Journal of Economic Cooperation and Development, **32**, 2 (2011), 1-18

Small and Medium Enterprises and Their Financing Patterns: Evidence from Malaysia

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The contributions of small and medium enterprises (SMEs) to socio-economic developments have been long recognized, in developed and developing countries alike. In this relation, a wide range of support programmes have been introduced and implemented in many countries. Malaysia is not exceptional to this as various SMEs-oriented policies and SME support initiatives have been nationally initiated. Among the most important areas of support extended to SMEs are financial assistance and credit facilities. Nonetheless, earlier studies indicated that the SMEs' outreach and accessibility to financial facilities, financing needs and pattern are different than of their larger firm counterpart. In view of this, this paper attempts to examine SMEs; their financing pattern and their accessibility to external debt finance based on 124 SMEs surveyed in Klang Valley, Malaysia. The findings revealed that start up SMEs do not require much external funding for set up, and besides they are commonly deficient of the means to obtain added funds. As SMEs grow and expand, the need for additional fund will arise, thus the external financial needs will start to increase even though the internal funds represent a significant proportion of their available funds. Among the SMEs that have obtained external finance, the amount and tenure of the funds tend to be small and short to medium terms respectively. The finding indicated that the age and assets of SMEs are insignificantly correlated to their accessibility to finance. Thus, the study concludes that a wide variety of financial facilities provided by various agencies and financial institutions lead to greater accessibility to finance SMEs in the country.

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1. Introduction

The financing needs and behavior of small and medium sized enterprises (SMEs) should be given prior attention as these establishments play a significant role in the development of most economies around the globe. They have contributed significantly in the development of increasing the nations' Gross Domestic Product (GDP) as well as creating jobs and employment opportunities (Bank Negara Malaysia, 2007). Besides, they have also made valuable contributions in the generation of regional income and savings, facilitation of trainings, stimulation of competition; besides aiding large firms, innovations and inventions, and hence become impetus for economic growth and development (Hall, 2002). The growth and development of SMEs have remarkably contributed to not only employment creation, but also through it, poverty reduction (UNDP, 2007).

The important role of the SMEs as an engine for development could be hampered if the essential elements that contribute to their performance are not catered well by the public and private sectors of the economy. One of the essential elements for the successful performance of the SMEs is the availability and accessibility of financing. The significant contribution and importance of financing to the SMEs have encouraged the government of Malaysia to offer increased support initiatives so to ensure that the financing requirement will not be a hurdle for the development of these enterprises. Huge amount of funds have been made available to SMEs via various schemes and programs. In fact, credit guarantee facilities have been introduced to make the funds more accessible to SMEs, and furthermore, debt resolution scheme has been set up to facilitate the restructuring of SMEs which are viable but being burdened with non-performing loans (NPLs).

Nevertheless, the abundance of loan facilities coupled with the demanding approval requirement of the scantily available equity funds has led many of the SMEs to resort to debt financing. This presents a challenge to SMEs as most banks are more inclined to support secured businesses requirement for financing. This is especially so in Malaysia. Besides conventional banking system, the Islamic banking system is no less different as they would rather mobilize their funds to more-secured financings though there are many other modes of Islamic financing particularly profit-loss sharing (PLS) equity financing and as such that could be utilized competitively (Hamid and Ahmad, 2001).

Previous studies pertaining to the use of debt vis-à-vis equity financing had so far been focusing on the problems and limitations faced by the financial and non-financial institutions in extending funds to the SMEs. Yet, very little attention is given to the definitive needs of the fund users; in this case, the SMEs, in relation to the use of the financing facility. Thus, this paper attempts to examine the selection of the financing pattern of the SMEs as well as their accessibility to the financing facilities provided by the agencies and financial institutions in Malaysia. In the following sections, a brief review of literature on financing SMEs is presented before a research method is highlighted. Subsequently, findings on characteristics of SME owner managers and their enterprises are discussed, followed by the results from financing pattern of SMEs and their accessibility to external debt finance, respectively.

2. A Review of Literature on Financing SMEs

The SMEs in several advanced economies are comprised of over 98% of total establishments and contributed to over 65% of employment as well as over 50% of the GDP (Bank Negara Malaysia, 2007). It is recorded that SME employment ranges from about 50 to 80 percent of the workforce in the Asia Pacific region (Moha Asri, 2001; Hall, 2002). The status and development of SMEs are also essential to the Malaysian economy. In Malaysia, SMEs in the manufacturing sector refer to establishments with not more than 150 full time employees and sale turnover of not more RM25 million. However, the definitions of such establishments are slightly varied across different economic sectors (SMIDEC, 2009). SMEs contribution was amounted to RM4.3 billion or around 20 percent of the GDP in 1990 and was projected to increase to around RM120 billion by 2020 (Moha Asri and Zarinah, 2008). According to UNDP (2007), employment created by Malaysia's SMEs was approximately 3 million or about 65.1 percent of the total employment. SMEs in Malaysia account for 99 percent or 519,000 of total establishments in the three economic sectors of manufacturing, services and agriculture (UNDP 2007:3).

Much of the discussions pertaining to the SME financing are centered on the issue of information asymmetry that exists in the financial market. The prominence of information asymmetry among the SMEs had created the problems of financial constraint and credit rationing, which then affected the enterprise growth and performance. Information asymmetry refers to the situation where all relevant information is not known by the interested parties (Peirson et. al., 1999). This is typical of the SMEs where insiders (owners/managers/borrowers) generally have better information about their abilities, level of effort, preferences and firm's prospect than the outsiders (shareholders/lenders).

In the world of imperfect capital market, information asymmetry that exists between insiders and outsiders is more pronounced among the SMEs compared to the large-sized firms. Large firms are mostly regulated by the security commission which sets certain standard of disclosure requirement such as the financial status is to be made public with the issuance of periodical reports and prospectus prior to the new issuance. Hence, the large firms are not subject to severe information asymmetry. On the other hand, smaller firms are not publicly regulated and there is no pressure for non-disclosure of their financial status. Hence, SMEs generally kept their internal information to themselves. The outsiders, particularly the banks have very little knowledge about them instead. This had caused them to be subjected to more severe information asymmetry.

The impact of information asymmetry can be ex-ante and ex-post (Scholtens, 1999). Ex-ante information asymmetry refers to the fact that lenders and financiers have very little information on the definitive value of the SMEs as they are generally close in nature. They are generally being controlled by one or few persons and they have fewer disclosure requirements (Hall et al., 2000). As a result, the lenders or financiers may have had difficulty in identifying the best-returned firms, may have entered contractual arrangement with poorly qualified firms or may have made contractual arrangement that created incentives for under performance of the firms. These are referred to as adverse selection problems.

Furthermore, the main concern and consideration of lenders and financiers is not to recognize the downside of the borrowers' businesses, but to anticipate the return of the principal plus interest. Therefore, they will minimize (or eliminate) all possible loss or downside risks by securing the debts with collateral against any default. Since SMEs are generally young and while they own more intangible assets, they find it difficult to get access to debts at cheaper costs as they are considered risky financially. Besides, collecting specific information about the firms as well as processing and interpreting them is costly. This had caused the lenders to charge smaller firms a high cost of credit on financing. Consequently, SMEs with high potential of profitable investment may not get sufficient finance at reasonable cost or may not get the finance at all. If they obtain the financing, they will have to pay a price higher than that is normally paid by larger counterparts (Petit and Singer, 1985; Apilado et. al., 1992).

The ex-post information asymmetry may create an incentive for moral hazards on the part of the borrowers as they have the control over the firm (Jensen and Meckling, 1976; Harris and Raviv 1991; Scholtens, 1999). They may mismanage the financial funds at hand, may increase the risk of investment, may reduce their managerial effort and as such. As lenders and financiers have anticipated this behavior, they normally perform credibility screening prior to giving the loans and monitoring via greater covenants in the contract. SMEs are generally imposed with greater covenants compared to those of larger enterprises (Apilado et al., 1992). The writing of these covenants is not cost-free, and lenders would normally take these costs into account by including them in the price of the debt. Consequently, the transaction costs incurred by smaller borrowers would normally be higher, hence further squeezing their financial accessibility to debts.

The impact of information asymmetry, as discussed in the economic literature, leads to a certain pattern of SME financing behavior. In addition, the relative size and age of SMEs, which are generally smaller and younger than larger companies, had caused them to have somewhat different nature and constraints, as far as financing is concerned. Apart from the issue of information asymmetry, the size and age of enterprises also play a considerable role in determining the pattern of SME financing throughout their development. Berger and Udell (1998), in describing the economy of SME financing, proposed a model which depicts that firms lie on a size/age/information continuum where the smaller or younger firms “lie near the left end of the continuum indicating that they must rely on initial insider finance, trade credit and/or angel finance” (Berger et. al. 1998, p.622). As the firms get larger and older, and if the firms remain in existence, external finance will be sought after to finance ongoing businesses as the access becomes easier.

The SMEs’ heavy dependency on insider finance for initial funding is theoretically and empirically appealing because during the start up stage, the firms are still developing their products and have assets mostly in the form of intangibles. Hence, they have no available balance sheet that reflects their eligibility to collateralize their asset for external financing requirement. In addition, external financiers initially could not observe the definitive quality of the firms due to information asymmetry. Hence, financiers (i.e. banks) would normally impose high premiums or interest rates and ration the credits to secure against any possible risk of agency problem. This has further limited the SMEs’ access to external finance. Only when the firms are mature, have more established relationship with banks and have more disclosure about their reputation will the bank lower the credit rate and lessen the credit rationing. Previous empirical studies (such as James, 1986; Hamilton and Mark, 1998; Levenson and Willard, 2000; Beyene, 2002; Cassar, 2004; Tambunan, 2006; Deogratius, 2007) verified the fact that most SMEs are dependent much on insider finance for initial funding.

3. Methods of Study

The present research is done based on descriptive statistical method with a minimum quantitative analysis. Descriptive study is undertaken to describe the characteristics of the samples i.e. small and medium sized enterprises inclusive of the owner’s background and general information of the enterprise. The population of this study comprised of the small and medium-sized enterprises (as defined by SMIDEC 2006). The population frame of the study was the listing of SMEs which operate their businesses in the area of Klang Valley, Malaysia. A proper sampling technique is important in order to have a precise and unbiased sample that represents the whole population. A total of 600 samples were drawn from the population to be adopted in this study. A set of questionnaire was distributed to each of the selected samples via personally-administered survey from between February and November

2007. Two methods of personally-administered survey were normally used i.e. drop-off and mail. Follow-up phone calls were conducted to each of the samples in order to check their acceptance and response. Using Statistical Package for Social Science (SPSS), the profile of the firms and their owners/managers was analyzed descriptively in the form of simple statistics.

Out of the total 600 distributed questionnaires, only 124 questionnaires (with 21 percent response rate) questionnaires were returned. The low response rate could be attributed to the reluctance of some targeted respondents to spend much time in responding to all the questions in advance. Nevertheless, the 21 percent response rate of this study is deemed favorable compared to that of similar study conducted previously in this field (Moha Asri, 1999).

4. Research Findings

The present research findings are divided into three main sections. The first section describes the findings on characteristics of SMEs and its owner-managers. The second section discusses on financing pattern for starting up SMEs and on-going businesses as well as their sources of debt. The third section concentrates on the accessibility of SMEs to external debt finance based on the preceding findings in this research.

4.1. Characteristics of SMEs Owner-Managers and their Enterprises

Most respondents (92 or 74.2 percent) are owners of the enterprises and majority of them are male (78 or 62.9 percent), followed by female (46 or 37.1 percent). This finding is relatively consistent with Malaysia's business environment where the number of male business owners dominates the female though the latter is increasing in number. Nevertheless, many of the owner-managers (OMs), are within the age range of 40 with the average age of 40.2 years. It is found that the majority of the surveyed OMs have had a 10-year business experience. With regards to educational level, many of the surveyed OMs have bachelor's degree (45.2 percent), and quite a significant number of them have professional certificate or diplomas (40 or 32.3 percent).

Table 1: Characteristics of Owner-Manager & Their Enterprises

Characteristics of Owner-Manager (n=124)	Number	Percent
Gender:		
Male	78	
Female	46	
Ethnic:		
Malay	113	91.1
Chinese	11	8.9
Indian	0	0
Others	0	0
Educational Level:		
Primary School	0	0
Secondary School	13	10.5
Certificate/Diploma	40	32.3
Bachelor's Degree	56	45.2
Master	14	11.3
Ph.D	1	0.8
Characteristics of Enterprises (n=124)	**Number**	**Percent**
Business Type:		
Construction	10	8.1
Manufacturing	27	21.8
Retailing	24	19.4
Wholesale	6	4.8
Service	49	39.5
Agro-aqua	3	2.4
Tourim	1	0.8
Others	4	3.2
Ownership structure:		
Family	6	4.8
Sole proprietorship	22	17.7
Partnership	9	7.3
Private Limited	87	70.2
Management:		
Owner	92	74.2
Manager	32	25.8

The majority of the enterprises surveyed are engaged in the service sector (72.6 percent), some are engaged in manufacturing (21.8 percent) and only a small number of them are in agriculture or agriculture-related businesses (2.4 percent). In terms of ownership structure, the survey disclosed that about 70 percent of the enterprises are private limited while the others are sole proprietorship (17.7 percent), partnership (7.3 percent) and family-owned businesses (4.8 percent). Consistent with their structure as small and medium-sized, the majority of the enterprises are managed by their owners (86.3 percent) and only some are managed by managers (13.7 percent).

The average age of the enterprises is seven while the dominant age is four. This indicates that many of the enterprises are still in their early stage of development. The enterprises under survey employed quite a significant number of employees, as the average size of employment is 21. The maximum number of employees employed by a given enterprise in this study is 147. An in-depth study of the employees based on their ethnic background indicates that the majority of them are Malays (72.9 percent) while Chinese and Indian constitute only small percentages (6.07 percent and 2.5 percent respectively). Not surprisingly, quite a significant number of foreign workers (immigrants) are employed (18.9 percent) and this number surpasses the total sum of Chinese and Indian employed by the enterprises. Interviews with several employers disclosed that the main reason for the significant number of foreign workers is their willingness to work hard at reasonable (or sometimes cheaper) wages.

The products sold by the surveyed enterprises are diverse, ranging from the minimum of one product up to more than twenty products, with the average of three products sold. These products are mainly sold in the local market i.e. in their respectively locality comprising 54.8 percent, while another 18.6 percent sold their products regionally, i.e covering a few neigbouring states. Furthermore, about 22.6 percent reached national market, while only a small percentage of their products, i.e. 4.0 percent marketed internationally. This finding is consistent with the data reported by the SMIDEC, where the SMEs in Malaysia contributed not more than 20 percent of output for export (SMIDEC 2006).

4.2 SMEs' Financing Patterns

To obtain funds to start-up a business is a challenge especially to smaller size enterprises as many entrepreneurs have no hands-on experience in business, hence they are perceived to lack credibility in the eye of fund providers. The experiences of many SMEs around the world indicate that most of them used internally generated funds in the form of personal savings or the savings of their family (James 1986, Beyene 2002 and Deogratius 2007).

This study verified the fact that many of the surveyed enterprises utilized their own funds for starting up the businesses (75.8 percent). Those who sought external equity obtained their funds mainly from partners or development institutions. Approximately 12 percent of the enterprises obtained the start-up funds from development institutions i.e. Perbadanan Usahawan Nasional Berhad (PUNB) and 10.5 percent of them acquired funds from their business partners. Only a very small percentage (1.6 percent) of them received start-up funds from other sources such as banks or government grants.

This study revealed that majority of the enterprises (56.5 percent) still prefer internal funds as the main source of external funding as far as equity is concerned. The surveyed enterprises borrowed a wide-ranging amount of money for their operations. Of the total borrowers, 44.7 percent of them borrowed less than RM50,000 while 25 percent borrowed quite a large amount of loan i.e. more than RM1 million. A little more than 20 percent of the enterprises borrowed between RM100,000 to RM500,000 while another 6.4 percent borrows between RM500,000 to RM1 million. Loan amount of RM50,000 to RM100,000 are borrowed by 2.1 percent of the enterprises surveyed. With regard to the tenure of loan, finding revealed that the enterprises in Malaysia rely more on short (less than three years) and medium-term (three to five years) debt finance (57.4 percent) though quite a significant number of them (42.6 percent) have access to longer term loans (above than five years).

4.3. Accessibility to External Debt Finance

A significant number of the surveyed enterprises (81 respondents or 65.3 percent) had recently applied for loans; of which 50.6 percent had applied for a new loan, 35.8 percent had applied for additional loan, and the rest (13.6 percent) had applied for additional repayment period for their loans. Of those enterprises that borrowed new funds or sought extension on their existing loans or repayment period, 72.8 percent were successful in their first application while 14.8 percent succeeded after more than one application. Only 12.3 percent of the applying enterprises did not succeed in their application.

The high percentage of successful application for SMEs financing, as found in this study, is consistent with the previous study (Moha Asri, 1999) in the field. This high access to financing could be due to the various guarantee schemes provided by especially the various funding institutions via Credit Guarantee Corporation (CGC).

Cross tabulations were conducted between age and accessibility and between assets and accessibility to examine if the two variables may have influence on the enterprises' access to debts. A 2 x 2 contingency table was employed in order to derive a more accurate chi-square test. Hence, data for the two variables i.e. age of enterprises and their assets were regrouped. Table 2 displayed the outcome of cross tab between enterprises' age and access to finance. The enterprises were categorized into; 10 year or less (Birth Stage) and more than 10 years (Growth Stage)[2]. The table showed that a total of 55 enterprises at Birth Stage had recently applied for loans and of these, 43 had their applications approved (78.2 percent of the total birth-stage-enterprises that applied) and only 12 (or 21.8 percent) experienced some difficulty in getting their loans approved or not approved at all. In comparison, a total of 26 growth enterprises had recently applied for loans and of these, 16 (or 61.5 percent) had their applications approved and 10 (or 38.5 percent) experienced some difficulty in getting their loans approved or not approved at all. Cramer's V test for the two variables (age and access) however indicated that there is a very weak association between the age of enterprises and their status of loan approval (Cramer's V statistic = 0.2). This association is indeed insignificant as the chi-square test observed a value of $p = 0.1$ ($p > 0.001$).

[2] This categorization is based on Miller and Friesen's (1984) stages of firms where the small and medium-sized enterprises were generally placed at Birth and Growth stages. According to them, firms at Birth Stage are less than 10 years old, have informal structure and dominated by owner-manager.

Table 2: Cross Distribution between Age of SMEs and Their Accessibility to Finance

			Loan Approval		Total
			Approved	**Difficult/Not Approved**	
Age	10 year or less	Count	43	12	55
		Expected Count	40.1	14.9	55
		% within Age Category	78.2	21.8	100
		% within Loan Approval	72.9	54.5	67.9
		% of Total	53.1	14.8	67.9
	More than 10 years	Count	16	10	26
		Expected Count	18.9	7.1	26
		% within Age Category	61.5	38.5	100
		% within Loan Approval	27.1	45.5	32.1
		% of Total	19.8	12.3	32.1
	Total	Count	**59**	**22**	**81**
		Expected Count	59	22	81
		% within Age Category	72.8	27.2	100
		% within Loan Approval	100	100	100
		% of Total	72.8	27.2	100

Note: *Chi-square Test ($p = 0.1$), Cramer's $V = 0.2$*

The outcome of cross tabulation between assets and access to finance displayed a similar result. Theoretically, bigger enterprises should have better access to finance. However, findings of this study indicated that assets exert no influence on SMEs in gaining access to finance. As shown in Table 3, a total of 54 smaller enterprises had applied for loans and of these, 38 (or 70.4 percent) had their loans approved with only one application and the rest of 16 (or 29.6 percent) succeeded after more than one application, or did not succeed. Comparatively, a total of 27 bigger enterprises had applied for loans and of these, 21 (or 77.8 percent) succeeded in their applications and 6 (or 27.2 percent) succeeded after more than one application, or did not succeed. Cramer's V statistic and chi-square test for assets and access to finance indicated that the two variables are not significantly related. The insignificant findings for both age and asset of enterprises with access to finance could mainly be due to the fact that a wide variety of financial facilities were offered by as many as 13 ministries and 30 government agencies or institutions with varying assistance activities (Moha Asri, 1999).

Table 3: Cross Distribution between SMEs' Assets and Accessibility to Finance

			Loan Approval		
			Approved	**Difficult/Not Approved**	**Total**
Asset	< RM1million	Count	38	16	54
		Expected Count	39.3	14.7	54
		% within Asset	70.4	29.6	100
		% within Loan Approval	64.4	72.7	66.7
		% of Total	46.9	19.8	66.7
	> RM1million	Count	21	6	27
		Expected Count	19.7	7.3	27
		% within Asset	77.8	22.2	100
		% within Loan Approval	35.6	27.3	33.3
		% of Total	25.9	7.4	33.3
	Total	Count	**59**	**22**	**81**
		Expected Count	59	22	81
		% within Asset	72.8	27.2	100
		% within Loan Approval	100	100	100
		% of Total	72.8	27.2	100

Chi-square Test (p = 0.4), Cramer's V Statistic = 0.1

5. Conclusion

SMEs contribute significantly to the economic growth and development of many countries. Some scholars tend to assume the role of SMEs as the 'backbone" of the economies of many countries (see for instance ABD, 1990 and Hall, 2002). This is evidently so in the point of view of generating employment, income, export, a source innovation, technology transfers as well as entrepreneurial development. The importance of SMEs in Malaysia is validated by their contribution to about 30 percent of the total GDP and is projected to increase to 50 percent or RM120 billion by the year 2020 (Moha Asri, 2002). The Malaysian government has realized this potential and a wide range of support programmes have been provided to further promote SMEs to the greater heights. However, less exploration on the accessibility of financial facilities and financing structure of SMEs has led to this research, with the aim to fill this gap and vacuum.

Based on the research analysis, it is found that the general profile of the SMEs in Malaysia is no less different than the general profile of other SMEs around the world. This is so as many of SMEs are owner-operated, dominated by male entrepreneurs, have fewer workers and lesser asset value than large enterprises, while SMEs are dependent much on internal sources of finance for start-up. It is also found that SMEs do not need much external funding and besides they are deficient of the means to obtain one. However, as SMEs grow and expand, the external financial needs will start to increase even though internal funds represent a significant proportion of their finances. For those SMEs that have obtained external finance, the amount and tenure of the funds tend to be small and short to medium terms respectively. The study concludes that a wide variety of financial facilities provided by various agencies and financial institutions lead to greater accessibility to finance SMEs in the country. This conclusion, nonetheless, should not be comfortable at all as stiff competition and global economic environment call for more innovative and progressive support strategies for SMEs to ensure that they are made an integral part of the total economic development in the country.

Hence, it can be stressed that although the government has stated its strong commitment to and interest in promoting small businesses, the intention has not been translated into effective action as yet especially with regard to start up SMEs. Similarly, the accessibility and adequacy of most of the support facilities provided at the level of individual businesses are found to be very much low. This may reflect the inflexibility on the part of the banking institutions to provide a much robust financial facilities for SMEs in the country. Realizing the significant role of SMEs to the country's economy, it is a high time now this situation should be reviewed and reexamined.

Internally, there is indeed scope and ample evidence that SMEs can substantially increase their efficiency and productivity, and that the rate of growth, and new enterprises can be established in a number of product lines and sub-industries in the wake of development in the country. On the whole, SMEs in Malaysia have plenty of scope and ample evidence that they can substantially increase their productivity and rate of growth in the wake of the Malaysian economic recovery, which in turn provides further impetus for SMEs' activities in the overall industrial development of the country. Faced with the current global business environment and a high level of business competition, SMEs will require to be more adaptive to maintain their present contribution to the Malaysian economy. While SMEs will need new strategic direction and planning and outward looking managers and entrepreneurs with knowledge and skills, the continued efforts and support of the government in enhancing the development of SMEs retains equally significant. All these require more commitment and hard work from both the public and private sectors to utilise and maximise the available resources and opportunities to ensure that SMEs are capable of meeting the challenges of globalisation.

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