

# Effect of Sources of Financing on Financial Performance of Small and Medium Enterprises in Northeast Nigeria

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## ABSTRACT

This study examines the impact of various sources of financing on the financial performance of Small and Medium Enterprises (SMEs) in Northeast Nigeria, Nigeria. The study specifically aims to assess how commercial bank loans, retained earnings, trade credit, and leasing affect the financial performance of SMEs in the state. The research is limited to data from 2015-2023, and a descriptive survey research design was employed. Primary data were gathered through questionnaires, and the analysis was conducted using multiple regression analysis. The target population consists of small, medium, and micro enterprises registered in Northeast Nigeria. A sample of 50 SMEs were selected from each of the six states in the Northeast Nigeria making a total of 300. Out of the 300 questionnaires distributed, 265 were retrieved and used for the study. The findings revealed that both commercial bank loans and trade credit had a significant positive impact on the financial performance of SMEs, while leasing had a significant negative effect. Retained earnings, however, were found to have no significant effect on the financial performance of SMEs in Northeast Nigeria. The study concludes that commercial bank loans, trade credit, and leasing are key factors influencing the financial performance of SMEs in the region. Based on these findings, the study recommends that SMEs in Nigeria should recognize the importance of financing sources as key determinants of their financial performance. It also suggests that SMEs should consider forming larger groups to access bigger commercial loans from banks.

## ARTICLE INFO

**Keywords:**  
*Financial performance, Leasing, Retained Earnings, Small and medium enterprises*



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Received: 20 Oct 2024 | Accepted: 08 Dec 2024  
Published: 25 Dec 2024

## 1. INTRODUCTION

Small and medium-sized enterprises (SMEs) are increasingly recognized as vital contributors to the economies of many countries. As a result, governments around the world are focusing on developing the SME sector to foster economic growth. In Nigeria, SMEs are seen as crucial for addressing issues such as job creation, sustainable growth, equitable income distribution, and overall economic stimulation (OECD, 2014). Access to financing is a key factor in the growth of SMEs, necessary throughout their lifecycle. The availability of funding sources is central to the success, development, and achievement of SME goals (Ou & Haynes, 2016). However, SMEs often face greater challenges in securing the necessary funds compared to larger enterprises, and they tend to report higher financing obstacles (Beck, et al, 2023). Recently, there has been consensus that improved access to diverse financing options can enhance SME performance, leading to both private and broader economic benefits. As such, access to various financial sources plays a major role in encouraging SME activities within any economy (Xavier, et al, 2023). Commercial bank loans are one of the most common external financing sources for many SMEs, which heavily rely on traditional debt to meet their startup and investment needs. Financial performance indicates a firm's financial stability over a given period and allows comparisons between businesses within the same industry or sector, helping companies plan improvements to achieve their objectives (Berger, et al, 2021). SMEs have access to both internal sources of finance, like retained earnings and owner savings, and external sources such as commercial bank loans, trade credit, leasing, and venture capital. This study explores how these various sources—commercial bank loans, retained earnings, trade credit, and leasing—affect the financial performance of SMEs in Northeast Nigeria, Nigeria. Over the years, the performance of Nigerian SMEs has declined, with many that once provided 40% of employment in the country closing due to unprofitability (National Bureau of Statistics, 2015). Finance is essential for the survival of any business, as no enterprise can thrive without sufficient funds for working capital, investment in fixed assets, skilled employees, and market development (Agnew, 2023). Therefore, access to diverse financial sources is crucial for any business's survival and performance.

SMEs utilize a range of financing options, starting with internal sources such as personal savings and retained earnings, to informal external sources like family and friends' financial support, trade credit, and

venture capital, and eventually to formal external sources such as commercial bank loans (Abdulsaleh & Worthington, 2023). Trade credit is a dynamic and important alternative to bank loans for SMEs, often serving as a buffer during liquidity challenges (Bello et al, 2020). Similarly, retained earnings are a key internal financing source, allowing SMEs to reinvest their savings into the business, reducing reliance on external funds. For growth and expansion, SMEs must use retained earnings to accumulate assets that generate income. Leasing is another important financing tool, offering an alternative to traditional loans by providing assets instead of cash, with government support potentially expanding access to this financing option (Berger & Udell, 2020). In Africa, there is limited empirical research on how SME financing sources affect their financial performance. Studies conducted in Kenya, such as those by Wafula, et al, (2016), and others, have explored this topic, but a similar research gap exists in Nigeria, especially in Northeast Nigeria. Although studies have been conducted in other regions of Nigeria, such as Lagos and Delta, no research has focused on Northeast Nigeria. Furthermore, no study has combined all four sources of financing for SMEs—commercial bank loans, retained earnings, trade credit, and leasing—which this research aims to address. This study focuses on SMEs in with assets between N5 million and N500 million and a workforce of 11 to 300 employees. It seeks to examine the impact of these financing sources on the financial performance of SMEs in Northeast Nigeria.

## 2. LITERATURE REVIEW

### 2.1 Concept of Financing Sources

Access to finance is vital for the continued and sustainable growth of SMEs. At each stage of their development, SMEs require financial support for their operations. Generally, there are four main scenarios when SMEs need to secure funding. First, start-up capital is needed to establish the business. Second, financing is required for expansion, such as purchasing property or machinery, or for working capital. In some cases, finance may also be used to acquire another business. The third situation involves financing for innovation, which can occur independently or overlap with the first or second stages. Finally, SMEs might need finance to adjust their financial structure, such as altering the balance between equity and debt or changing long-term debt to short-term debt, or vice versa. SMEs have several options for raising finance. According to Oncioiu (2022), financing can come from both internal and external sources. The advantages of

internal financing include maintaining independence and financial autonomy, as it does not create additional obligations like interest or guarantees. It also preserves borrowing capacity and provides a reliable source of financial support. However, there are drawbacks, as owner-managers may have fewer resources to invest in more profitable ventures outside the business generating the surplus. In contrast, external financing becomes necessary if SMEs lack enough internal resources to fund their planned activities.

## 2.2 Commercial Bank Loans

Banks are crucial for financing SMEs, especially since these businesses often face challenges accessing equity markets. Bank loans involve specific sums of money with defined terms and conditions, provided to entrepreneurs to help them start, grow, or sustain their businesses. However, obtaining finance from banks can be challenging due to issues like asymmetric information. To overcome this, banks should offer financial products tailored to SMEs' needs while addressing these risks. The literature identifies four main lending techniques: financial statement lending, asset-based lending, credit scoring lending, and relationship lending.

## 2.3 Retained Earnings

Retained earnings are profits not distributed as dividends but reinvested in the business. They are a key method of internal financing, as the company reinvests profits for business diversification. According to Donaldson (2016), retained earnings give management full control over their use. Krishnamurthy and Sastry (2021) note that retained earnings play an essential role in securing investment funds, particularly when external funding is limited due to poor profits.

## 2.4 Trade Credit

Trade credit is one of the most significant external financing sources for SMEs. According to Berger and Udell (2020) as well as (Cohen, 2022) it accounted for about one-third of total SME debt in the U.S. in 1998. Trade credit involves delayed payments for goods or services based on agreements between suppliers and firms. Its widespread use is often driven by either transaction or financing motives. Fatoki and Odeyemi (2020) argued that new SMEs prefer trade credit, especially when the risk of default is high early in their operations. In countries with underdeveloped banking systems, trade credit plays an even more crucial role, as seen in China, where it contributed significantly to economic growth despite limited formal external financing.

## 2.5 Leasing

Leasing is a common financing method for SMEs, where a lender (lessor) purchases assets and rents them to a borrower (lessee) under a specified contract. The contract includes terms such as the lease length, payment amounts, and conditions at the end of the lease. SMEs have different leasing options based on their industry, such as operational leases, financial leases, and full maintenance leasing. The lease may also provide options for the lessee to either return the asset, buy it, or extend the lease (Nakusera et al., 2018).

## 2.6 Concept of Financial Performance

Financial performance refers to the ability of micro and small enterprises (MSEs) to function effectively, generate income, survive, and grow by leveraging opportunities and mitigating risks in their environment. It measures how efficiently a business uses its resources to maximize profits and wealth. Financial tasks, such as accounts, profit and loss statements, and balance sheets, are analyzed periodically to assess the success of the business (Srinivas, 2023). Financial reports are essential for evaluating the performance of small and medium enterprises (SMEs) against both internal and external financial conditions to ensure proper resource utilization and predict future capacity (Levasseur, 2022). It's noteworthy that factors beyond the nature of debt—such as the distribution of power between debt holders and business owners—can influence the impact of debt financing on financial performance. The performance of SMEs can be assessed using objective, subjective, or operational measures (Schayek, 2021).

## 2.7 Concept of Small and Medium Enterprises (SMEs)

The definition of micro and small enterprises varies between countries based on factors such as staff size, value of non-current assets (excluding land and buildings), and turnover rate. The main goal of micro and small enterprises is to provide employment opportunities and reduce poverty (Onoja & Ovayioza, 2015). In Nigeria, businesses are categorized into small, medium, and large enterprises, but there is no single definition for SMEs. Instead, the definition is based on characteristics such as project costs, turnover, number of employees, ownership structure, and capital investment (Akinsurule, 2022; López-Gracia & Sogorb-Mira 2021). The Nigerian Federal and State Ministries of Industry and Commerce use the value of fixed capital to define SMEs. The Small and Medium Scale

Industries Development Act of 2003 defines SMEs as having between 10 and 199 employees and assets (excluding land and buildings) ranging from 5 to 499 million Naira. SMEs in Nigeria make up 75% of all registered companies, many of which evolved from cottage industries. SMEs are present in diverse sectors, including manufacturing, agriculture, services, hospitality, financial intermediation, real estate, education, construction, and mining.

**Table 1.** Classification of SMEs in Nigeria

S/N	Size Category	Employment	Assets (=N=Million) (Excluding land & buildings)
1.	Micro enterprises	Less than 10	Less than 5
2.	Small enterprises	10 to 49	5 to less than 50
3.	Medium enterprises	50 to 199	50 to less than 500

Source: SMEDAN Report, 2024

Micro Enterprises are businesses with total assets (excluding land and buildings) of less than five million Naira and a workforce of no more than ten employees. Small Enterprises have assets (excluding land and buildings) between five million and fifty million Naira, and employ more than ten but fewer than fifty people. Medium Enterprises are those with assets (excluding land and buildings) ranging from fifty million to five hundred million Naira, and employ between fifty and 199 individuals. In cases where there is a conflict between asset value and employee count for classification (e.g., a business with assets worth seven million Naira but only seven employees), the classification based on the number of employees will take precedence, and the business will be classified as micro.

## 2.8 Empirical Review

### 2.8.1 Commercial Bank Loans and Financial Performance

Oke and Aluko (2015) examined the impact of commercial banks on financing SMEs in Nigeria from 2002 to 2012. The study found that commercial bank loans significantly influenced SMEs' financing, with factors such as the ratio of loans to total credit and the equity of commercial banks explaining significant portions of financing changes. Chimaleni et al. (2015) studied the effect of commercial loan financing on SMEs' financial performance in Lurambi Sub-County, Kenya, and found a significant impact. Other studies, such as those by Manini et al. (2016) and Amsi et al. (2017), further confirmed the positive impact of various financing sources on SMEs' financial performance. However, results from Kenya may not be directly applicable to Nigeria.

### 2.8.2 Retained Earnings and Financial Performance

Dagogo and Ohaka (2022) explored various financial strategies in small Nigerian businesses, finding that financial bootstrapping had the most significant impact on business financing. Ruri (2017) assessed the effects of equity, retained earnings, and debt capital on SMEs' financial performance in Kenya, concluding that equity and debt had a notable effect, while retained earnings did not. Studies such as Ruri and Omagwa (2018) confirmed that equity and debt were significant, but retained earnings were not.

### 2.8.3 Trade Credit Financing and Financial Performance

Mungiru and Njeru (2015) studied the effect of informal finance, such as self-help groups, family, and trade credit, on SMEs' performance in Kenya, concluding that trade credit had a positive effect. Similarly, Kapkiyai and Mugo (2015) found that trade credit positively impacted liquidity, profit margins, and return on assets in Kenyan SMEs. However, Akinbobola and Obamuyi (2018) noted that trade credit had a negative impact on the profitability of SMEs in South-West Nigeria, suggesting that ineffective management of trade credit contributed to this negative outcome.

### 2.8.4 Leasing and Financial Performance

Studies on lease financing, such as those by Kibuu (2015) and Bello et al. (2016), indicate a positive relationship between lease financing and financial performance, though some studies, like Kibuu's, suggest that while there is a positive association, the effects were not statistically significant. Other research by Wafula et al. (2016) and Alkhazaleh and Al-Dwiry (2018) supports the view that lease financing significantly impacts the financial performance of firms, especially in industries such as oil and gas and in government sectors.

## 2.9 Theoretical Framework

The Pecking Order Theory, introduced by Myers (1997) and Myers and Majluf (1984), arises from the idea that financial markets are characterized by asymmetric information. Insiders have more knowledge about a firm's future prospects than outsiders, such as investors. This

theory suggests that a firm's capital structure decisions are influenced by its age, with internal funding sources being preferred first. External financing is only considered once internal resources are depleted. Specifically, firms prioritize using internal equity over external debt, short-term debt over long-term debt, and external debt over issuing equity. Consequently, the typical financing preference order for a firm is: internal equity, debt issuance, and then equity issuance (Cassar & Holmes, 2023). Literature on Small and Medium-sized Enterprises (SMEs) offers reasons for this preference, both on the demand side and the supply side (Lucey & MacanBhaird, 2022). On the demand side, SMEs' owner-managers generally want to maintain control over their business. To finance their firms, these managers typically start with personal savings and retained earnings, followed by short-term borrowing, long-term debt, and lastly, introducing new equity investors. On the supply side, SMEs often face challenges obtaining debt financing at market interest rates, which can lead to underinvestment problems (Brealey & Myers, 2021).

### 3. METHODOLOGY

The research adopted a descriptive survey research design. The target population consisted of small, medium, and micro enterprises (SMEs) registered in Northeast Nigeria. The study established specific criteria for sampling: the SMEs must have assets (excluding land) valued between N5 million and N500 million, and a workforce of 50 to 199 employees. A filtering sampling technique was applied to identify 50 from each of the six states in the region making a total of 300 sampled SMEs. Data was collected through questionnaires, with the primary data collection methods being self-administration and the drop-and-collect technique. In this approach, the researcher and research assistant left the questionnaires with an informant and returned later to collect them. SME owners or their managers completed the questionnaires with proper guidance, often face-to-face, and the completed questionnaires were picked up by the research team. Data collection took about two months. The questionnaires that were successfully retrieved are 265. To assess the content validity of the questionnaires, the Cronbach alpha content validity index was used, yielding a value of 0.8, confirming the instrument's validity. A content validity index of at least 0.5 is considered sufficient. Content validity was further supported by discussions with research experts. The measurement scales used in the questionnaire effectively reflected key elements of commercial loan financing, retained earnings financing, trade credit financing, hire purchase, and financial performance, as outlined in the literature. These measures, previously validated in other studies, were deemed valid for this research.

#### 3.1 Reliability of the Instruments

**Table 2:** Summary of Cronbach's Alpha Test Results

Variable	Cronbach Alpha	Number of Items
Commercial Bank Loan Financing	0.911	7
Retained Earnings	0.936	7
Trade Credit Financing	0.902	7
Hire Purchase	0.941	7
Financial Performance	0.922	7

Source: Compiled from SPSS Output, 2024.

Cronbach's Alpha ( $\alpha$ ), a method for assessing internal consistency, was employed to evaluate how well the questions aligned and measured the characteristics and behaviors within the test. The computed Cronbach's Alpha values for the measurement scales, as shown in Table 2, indicate the following: commercial bank loans had an  $\alpha$  of 0.911, retained earnings financing had 0.936 trade credit financing had 0.902, hire purchase had an  $\alpha$  of 0.941, and financial performance had 0.922. These values are well above the recommended threshold of 0.6, suggesting that the measurement scales were reliable. Therefore, the internal consistency of the measures was sufficiently high to ensure that the study variables were adequately assessed. This allowed for further testing and analysis using a linear regression model. Data were analyzed with multiple regression analysis to explore the impact of financing sources on the financial performance of SMEs in Northeast Nigeria, Nigeria. The regression model used for the estimation of a dependent variable for many independent variables is estimated as follows:

$$FPF = \beta_0 + \beta_1 CBL + \beta_2 RET + \beta_3 TCF + \beta_4 LEF + \epsilon$$

Where:

FPF=financial performance

CBL=commercial Bank loan

RET=retained earnings

TCR =trade credit

LEF=lease financing

$\beta_0$  = is the intercept of the regression line

$\beta - \beta_0$  is the intercept of the independent variables

$\epsilon$  = is the error term

## 4. DATA ANALYSIS AND RESULTS

### 4.1 Descriptive Statistics of Variables

**Table 3:** Descriptive Statistics

Statistics	FPF	CBL	RET	TCR	LEF
Mean	2.4460	2.4331	3.2424	2.9110	3.4432
Max	4	4	4	4	4
Min	1	1	1	1	1
Sd	0.92312	0.71294	0.65993	0.74193	0.4765
Observation	265	265	265	265	265

Source: Compiled from SPSS Output, 2024.

Table 3 indicates that the average value of FPF is 2.4460, with a minimum of 1, a maximum of 4, and a standard deviation of 0.92312. Since the standard deviation is smaller than the mean, it suggests that the data is not highly spread out from the mean. The table also shows that the average value of CBL is 2.4331, with a range from 1 to 4 and a standard deviation of 0.71294. RET has an average of 3.2424, with a minimum value of 1, a maximum of 4, and a standard deviation of 0.65993. Similarly, the standard deviation of TCR, which is 0.7493, is lower than the mean value of 2.9110, indicating that the data is relatively close to the mean. Lastly, the mean value of LEF is 3.4432, with a minimum of 1, a maximum of 4, and a standard deviation of 0.4765. The study includes data from 69 respondents in total.

### 4.2 Multiple Regression Results

**Table 4:** Multiple Regression Results

Variable	Coefficient	Standard Error	t-statistics	Prob
C	0.400	0.322	1.234	0.203
CBL	0.383	0.425	2.233	0.018
RET	0.562	0.387	1.242	0.073
TCR	1.035	0.213	4.281	0.000
LEF	-1.002	0.494	-3.321	0.000
R2	0.949			
Adj. R2	0.946			
F-Statistics	296.335			
Prob (F-Statistics)	0.0000			

Source: SPSS Output, 2024

The F-statistic of 296.335 and a corresponding p-value of 0.0000 suggest that the model is well-fitted, with the independent variables appropriately selected, combined, and utilized. The coefficient of determination ( $R^2$ ) of 0.94 indicates that approximately 94% of financial performance can be explained by commercial bank loans (CBL), retained earnings (RET), trade credit (TCR), and lease financing (LEF). The remaining 6% is attributed to other independent variables not included in the regression.

### 4.3 Test of Hypotheses

**H01:** Commercial bank loans do not significantly impact the financial performance of SMEs in Northeast Nigeria, Nigeria.

The regression equation shows that a 1% increase in CBL leads to a 38% improvement in financial performance. With a p-value of 0.018 (less than 0.05), the null hypothesis is rejected, and the alternative hypothesis is accepted, indicating that commercial bank loans have a significant positive effect on the financial performance of SMEs in Northeast Nigeria. This suggests that increasing commercial bank loans for SMEs in Northeast Nigeria boosts their financial performance.

**H02:** Retained earnings have no significant effect on the financial performance of SMEs in Northeast Nigeria, Nigeria.

The regression shows that a 1% increase in retained earnings leads to a 56% increase in financial performance. However, with a p-value of 0.073 (greater than 0.05), the null hypothesis is accepted, indicating that retained earnings do not significantly affect the financial performance of SMEs in Northeast Nigeria.

**H03:** Trade credit has no significant effect on the financial performance of SMEs in Northeast Nigeria, Nigeria.

The regression equation shows that a 1% increase in trade credit results in a 103% improvement in financial performance. With a p-value of 0.000 (less than 0.05), the null hypothesis is rejected, and the alternative hypothesis is accepted, indicating that trade credit significantly improves the financial performance of SMEs in Northeast Nigeria. This suggests that increasing trade credit helps SMEs in the region enhance their financial performance.

**H04:** Lease financing has no significant effect on the financial performance of SMEs in Northeast Nigeria, Nigeria.

The regression result shows that a 1% increase in lease financing decreases financial performance by 100%. With a p-value of 0.000 (less than 0.05), the null hypothesis is rejected, and the alternative hypothesis is accepted, indicating that lease financing has a significant negative

impact on financial performance. This suggests that increasing lease financing results in reduced financial performance for SMEs in Northeast Nigeria.

## 5. DISCUSSION

The study accepts the alternative hypothesis, confirming that commercial bank loans have a significant positive effect on the financial performance of SMEs in Northeast Nigeria. This finding aligns with previous studies by Yemi, and Seriki (2018), Chimaleni et al. (2015), and Manini et al. (2016), among others. Regarding retained earnings, the coefficient value of 0.562 and a p-value of 0.073 (greater than 0.05) lead to the acceptance of the null hypothesis, suggesting that retained earnings do not significantly affect financial performance in Northeast Nigeria. This finding is consistent with studies by Ruri (2017) and Ruri & Omagwa (2018) but contradicts those by Manini et al. (2016) and Yemi and Seriki (2018). The study also finds that trade credit has a significant positive effect on financial performance, with a p-value of 0.000. This supports the alternative hypothesis, indicating that trade credit positively influences the financial performance of SMEs in Northeast Nigeria. This finding is consistent with Mungiru & Njeru (2015), Kapkiya & Mugo (2015), and Manini et al. (2016), but contradicts John-Akamelu, and Muogbo (2018). On the other hand, lease financing is found to have a significant negative effect on financial performance, with a coefficient of -1.002 and a p-value of 0.000. This suggests that lease financing negatively impacts financial performance in Northeast Nigeria, as financially sound organizations tend to use lease financing more. This finding contradicts studies by Kibuu (2015), Bello et al. (2016), Wafula et al. (2016), and Alkhazaleh and Al-Dwiry (2018).

### 5.1 Conclusion

This study concludes that financing sources have a significant impact on the financial performance of SMEs in Northeast Nigeria, Nigeria. It finds that commercial bank loans are a key factor, as increased loans to SMEs lead to better financial performance. However, the study also concludes that retained earnings do not play a significant role in improving SMEs' financial performance in the region. An increase in retained earnings does not necessarily translate to better financial outcomes for SMEs in Northeast Nigeria. On the other hand, trade credit is found to be a determinant of financial performance, with higher trade credit leading to improved financial results for SMEs. Conversely, lease financing negatively affects SMEs' financial performance, as an increase in lease financing hinders their financial success. Based on these findings, the study recommends that SMEs in Nigeria recognize the importance of their financing sources in determining financial performance. SMEs should collaborate and form larger groups to secure bigger commercial loans from banks, microfinance institutions, and other lenders, as these loans typically have lower transaction costs. By sharing these costs within the group, individual SMEs can reduce their financial burdens. Additionally, the study advises that SMEs focus on increasing retained earnings to enhance their financial performance. Retaining a portion of their profits for future financial needs or business expansion would be beneficial. SMEs in Northeast Nigeria should also actively utilize trade credit as a financing option to improve profitability. Finally, the study suggests that SMEs in Nigeria should consider venture capital and equity financing, as these sources provide start-up capital and offer valuable managerial and accounting support. Given that lease financing has not proven effective in improving SMEs' financial performance in Northeast Nigeria, venture capital can provide a more beneficial alternative, supporting both financial growth and operational efficiency.

### 5.2 Recommendations

Based on these findings, the study recommends the following

1. SMEs in Nigeria recognize the importance of their financing sources in determining financial performance. SMEs should collaborate and form larger groups to secure bigger commercial loans from banks, microfinance institutions, and other lenders, as these loans typically have lower transaction costs. By sharing these costs within the group, individual SMEs can reduce their financial burdens.
2. SMEs focus on increasing retained earnings to enhance their financial performance. Retaining a portion of their profits for future financial needs or business expansion would be beneficial. SMEs in Northeast Nigeria should also actively utilize trade credit as a financing option to improve profitability.
3. SMEs in Nigeria should consider venture capital and equity financing, as these sources provide start-up capital and offer valuable managerial and accounting support. Given that lease financing has not proven effective in improving SMEs' financial performance in Northeast Nigeria, venture capital can provide a

more beneficial alternative, supporting both financial growth and operational efficiency.

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