

# THE FINANCIAL INFORMATION GAP: THE FINANCIAL INTERMEDIARIES AND THE SMALL AND MEDIUM ENTERPRISES IN SRI LANKA

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## ABSTRACT

SME is the backbone of all developed and developing nations. So the development of this sector is paramount important for any country irrespective of their level of development. In this process, SME must gain satisfactory support from Financial Intermediaries through providing necessary financial facilities. However, the major obstacle for the development of SME in Sri Lanka is that, the lack of financial assistance of financial intermediaries since, there is a financial information gap exists between these two parties of Financial Intermediaries and SME entrepreneurs. The main objective study is to identify the reasons for prevailing financial information gap and make possible suggestions to minimize that gap in order to strengthen the backbone of the economy. Sample selection of the study confines to the SMEs cover within the scope of the definition for SMEs by the Industrial development Board of Sri Lanka. Sixty SMEs comprise thirty manufacturing enterprises, twenty service-providing enterprises and ten wholesale and retail enterprises located at Colombo administrative district and Horana AGA Division and fifteen Financial Intermediaries (commercial banks) were selected. With the help of quantitative research strategy, researchers concluded that, while SMEs give priority to produce information relating to Income Statement and Balance Sheet where as Financial Intermediaries prioritizes Cash flow information when evaluating loan applications. So, there is a Financial Information Gap exists between SMEs and Financial Intermediaries in Sri Lanka.

Keywords: Small and medium enterprises, Financial intermediaries, Financial information gap

## 1. INTRODUCTION

Small and Medium Enterprises (SMEs) are the backbone of all developed and developing nations since it plays an important role in economic development through creation of employment opportunities, mobilization of domestic savings, poverty alleviation, income distribution, regional development, training of workers and entrepreneurs, creating an economic environment in which large firms flourish and contribute for export earnings. Thus the development of this sector is paramount

important for any country irrespective of their level of development. But as Gamage (2003) concluded, the major obstacle for the development of SMEs in Sri Lanka is shortage of capital due to lack of access to financial facilities of financial intermediaries and lack of knowledge of bank procedures. The researcher's aim is to identify whether there is a financial information gap between SMEs and financial intermediaries and whether this gap is a obstacle to approach the financial facilities of financial intermediaries. The significance of the research objective is, by identifying the financial information produce by SMEs and financial

information requirement of Financial Intermediaries, both parties can maintain a better relationship.

## 2. LITERATURE REVIEW

### 2.1 THE VITALITY OF SMES FOR ECONOMIC DEVELOPMENT

Small business sector is vital segment of the economy not only from employment and production perspectives, but also from financial perspectives (Peter and Lewis, 1983). The existence of a strong and healthy small business community has always been recognized as the best way to preserve competition in capitalistic society, prevent monopolistic control of any industries, and thus assure the population of the benefits of competition through better prices and quality products (Steinhoff and John, 1991).

In Sri Lanka, the SME sector provides 28% of total employment, 7.5% of the total output and 7.0% of the value added in the industrial sector (Central Bank of Sri Lanka [CBSL], 1998). According to Hewaliyanage (as cited in Gamage, 2003, p.5) SME promote economic growth by import substitution as well as through direct exports, and they mostly supply goods and services to large directly exporting ventures and thereby contribute towards alleviating balance of payment difficulties.

Furthermore, this sector is essentially important for developing economies where unemployment and poverty are major problems (Gamage, 2003). The significance of SME to the Sri Lankan economy is presented in the Table 1.

### 2.2 IMPEDES HINDER THE SME GROWTH

Even though SMEs play a significant role in any economy they do not have access to the public market for money and cannot undertake public financing. Usually banks are unwilling to provide venture capital and a small proportion of loan facilities are provided to invest in plant. But SMEs' greatly need support from banks or other financial intermediaries (Bernard and Cahn, 1959; Stans, 1946). According to Schweiger (1958) small businesses are in trouble as results of the narrow to access to financial support of banks and other financial intermediaries and it may lead to inadequate financing. Struck and Mandell (1983) have identified that loan released to SMES are not more than one-third of total amount which they applied. Owualah (1999) stated that although the quality and comprehensive financial reports are required to reveal business success SMEs are unable to produce those reports. As a result of that most of the loan applications of SMEs have been rejected.

According to Shull (as cited in Struck and Mandell, 1983, p. 1026) banks and other financial intermediaries tend to lend principally to large businesses due to good relationship through adequate reporting which might diminish the supply of credit to small businesses.

Thus, there is a huge necessity to improve relationship between SMEs and financial intermediaries in way of producing quality financial reports in order to assess the business success and make easy approach for financial assistance, which required for SMEs.

Table 1: Contribution of small business to the economy of Sri Lanka

<i>Business type</i>	Units	Monthly production (Rs.)	Value Addition (Rs.)
Manufacturing	46,992	4,293,000	15,771,000
Service	17,045	395,200	2,467,000
Total	64,037	4,688,200	18,248,000

Source: Central Bank of Sri Lanka (as cited in Nishantha, 2006, p. 10)

Although the above literature emphasized the significance of financial information of SMEs for financial intermediaries, Marshall and Ketchum (1944) revealed that SMEs prepare profit and loss account, balance sheet as routine basis. But, other most important financial reports such as budgeting, variance analysis reports and cash flow statements do not produced due to lack of knowledge and less future orientation. Edwards and Turnbull (1994) argued that financial intermediaries are needed understand this situation and to change their attitude to accept SMEs' reports when providing financial facilities.

### **2.3 THE FINANCIAL INFORMATION GAP**

The above literature reveals that there is a conflict for financial information between financial intermediaries and SMEs when evaluating loan applications. This section focuses on literature, which combine the financial information conflict between financial intermediaries and SMEs.

Binks (1990) identified a gap in the financing of SMEs. In other words, financial intermediaries are more reluctant to provide loan facilities by accepting existing financial information. The researcher argued that this gap could be solved if banks were willing to lend on exiting financial information.

Meanwhile Berry (1993) argued that SMEs' financial reporting practices are not reliable due to various impedes. Thus SMEs must improve their reporting practices to generate quality and reliable information. Otherwise the loan evaluation process is ineffective and banks and other financial intermediaries will not agree to provide a sufficient amount of loan facilities to SMEs.

## **3. METHODOLOGY**

### **3.1 CONCEPTUAL FRAMEWORK**

The researcher developed the conceptual framework with the support of literature reviewed. It explains the variables focused on the research and their interrelationships. The conceptual framework is presented in the Figure 1.

### **3.2 HYPOTHESIS**

Considering the relationships in the conceptual framework the following hypothesis was developed.

H<sub>1</sub>: There is a financial information gap between financial intermediaries and SMEs.

### **3.3 SEGMENTS OF THE RESEARCH**

The research has two segments as follows.

1. The first area focuses on the SME sector financial information production.
2. The second section focuses on the financial information requirements of financial intermediaries.

A likert-scale is used to gather data for the first segment where as a likert-scale and open-ended questionnaire is used to gather data the in the second segment

### **3.4 SAMPLING**

The reseaecher has followed the judgement sampling method which is a non probability sampling method. The researcher chose the Colombo District and Horana AGA division as representative cities. The sample consist 60 SMEs and 15 financial intermediaries. The sample comprise 30 Manufacturing enterprises, 20 Service oriented enterprises and 10 whole sales and retail enterprises to represent all the sectors of SME. The samples of 60 SMEs are selected from Colombo administrative district and Horana AGA division. It is expected to select 30 SMEs from each Colombo district and Horana AGA division.

On the other hand 15 banks are selected to represent financial interediaries. All the selected banks are local banks because if careful consideration is given SME owners are reluctant to take service from foreign banks. Only one branch or a head office is selected from one local bank.

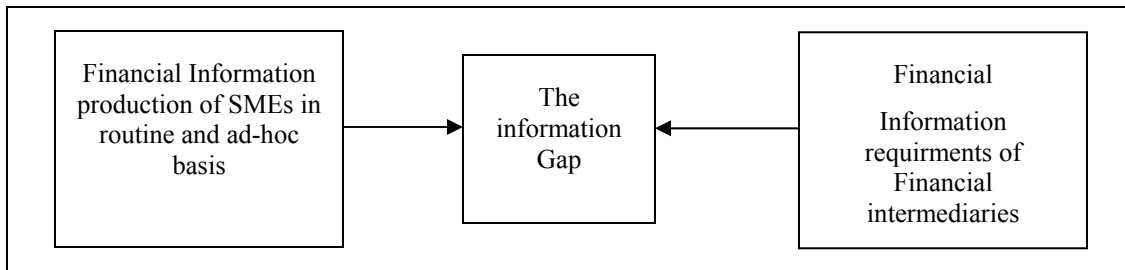


Figure 1: Conceptual framework  
Source: Researcher's own construction

Table 2 : Financial information production of SMEs

	N	Mean
We do not record information in a standard manner	60	2.5500
We produce profit and loss account periodically	60	2.8000
We produce cash flow statement periodically	60	3.1500
We maintain the income and expenditure account	60	1.8000
We maintain cash and other budgets periodically	60	3.8833
Valid N (list wise)	60	

Source: Researcher's own calculation

Table 3: Ranking financial information production of SMEs

Type of the Financial Report	Mean	Rank
Profit / loss Account and Balance Sheet	2.8	2
Cash Flow Statement	3.15	3
Income and Expenditure account	1.8	1
Cash and other Budgetary Reports	3.88	4

Source: Researcher's own calculations

#### **4. DATA PRESENTATION AND ANALYSIS**

##### **4.1 DATA ANALYSIS**

According to the findings in the Table 2 and 3, the following results can be drawn. The mean value of 2.5500 reveals that SMEs do not give significance to record financial information in a standard manner in routine basis. Whereas SMEs are given a priority to produce Income and Expense account periodically. The strong mean value of 1.800 and the rank of first reveal that conclusion. Furthermore the mean value of 2.800 states that SMEs produce Profit and Loss account and Balance Sheet periodically. But the production of Profit and Loss account and the Balance Sheet is having the second significance. Thus it is having second in the ranking. SMEs do not give an importance to produce cash Flow statement. The mean value of 3.1500 and rank of third reveals that conclusion. Surprisingly cash and other budgetary reports are rare in SMEs. The mean value of 3.8833, which is very close to 4 indicate that conclusion. Thus it is having the fourth in the ranking.

As a summary, SMEs give highest significance to produce Income and Expenses Account. The Profit and Loss account and the Balance Sheet are given the second priority. Surprisingly productions of Cash Flow Statement and budgetary reports are having third and fourth places respectively. The total numbers of respondents are 60 and the gathered qualitative information can be analyzed as follows.

Some owners of SMEs remarked:

We carry on the business without formal reporting practices. Whereas, we also maintain some books to keep records about daily transactions, but not in formal standard manner. But we are success in the market. So we do not assume formal reporting practices are essential for being success. But I also agree if there are formal reporting practices, we are able to access to financial facilities from intermediaries easily.

(Researcher's record; translated into English by the researcher)

Most of the SMEs have certain reporting practices, which combine formal and informal reporting practices. Some owners remarked:

We maintain cash book and income and expense account. But we do not record profit or loss in a standard manner due to various reasons. But if financial intermediaries request reports regarding

profit we take the help of a knowledgeable person in the accountancy field. Whereas these reports are also sometimes rejected by financial intermediaries.

(Researcher's record; translated into English by the researcher)

Most of the SMEs agreed that budgetary reports are having the highest significance when applying loans from intermediaries. they concluded:

Budgetary reports which state how they spend the loan amount are having highest significance when applying loans. Actually all the budgets are clearly in our mind but recording them in a standard manner is the main issue. We are not competent in accountancy and taking the help of accountancy people is a cost consuming activity if the loan amount is not a very high amount.

(Researcher's record; translated into English by the researcher)

Finally they agreed that there is a mismatch between reporting practices of SMEs and reporting requirements of financial intermediaries. Some of the owners of SME remarked:

I also agree that there is a mismatch between our regular reporting practices and intermediaries requirements. If the intermediaries are willing to accept our regular reporting practices that will be more reliable than our misleading and window dressed ad-hoc reports.

(Researcher's record; translated into English by the researcher)

A very small proportion of my sample concluded that they have formal reporting practice, prepare annual reports in a standard manner and banks are their regular lender for any of financial issues. It also indicates standard reporting practices are playing a significant role in the lending process.

##### **4.2 THE FINANCIAL INFORMATION REQUIREMENTS OF FINANCIAL INTERMEDIARIES**

Total numbers of respondents are 15 for the part I of the questionnaire and the data can be summarized as in the Table 4 and 5.

Table 4 presents the mean values calculated according to the financial intermediaries responses. The total number of sample is 15 and

all the responses are valid because questionnaires were correctly completed. Financial intermediaries believe they are playing a significance role by providing loan facilities to SMEs. The strong mean value of 1.3333 which is very close to 1 presents that result.

Meanwhile they agreed that proving financial information in a standard manner is having a greater importance when applying loan applications for SMEs. The mean value of 1.7333 presents that result. Financial intermediaries' give priority to Profit/Loss Account and Balance Sheet of SMEs for the current and past years when evaluating loan applications. Thus it is having the rank of first and the mean value of 1.5333 which is very close to 1.

The second significance or the rank of second is given for Cash and Other Budgetary reports and it is having the mean value of 1.800. The Cash flow statement is having the third significance when evaluating loan applications.

The mean value of 1.8667 and the rank of third reveal that result. In certain situations financial intermediaries request above three statements simultaneously. The rank of fourth and the mean value of 2.2667 reveal that conclusion. The following section focus on the qualitative data analysis.

According to the one of executive level employee in a bank remarked that financial intermediaries request financial reports from SMEs to identify their financial performance to ensure debts will be repaid. Moreover he said financial reports are the reliable way to identify SMEs' performance. Another executive officer in a bank remarked:

We request forecasted financial statements with reliable assumptions when evaluating loans. But most of the forecasted reports provide by SMEs are not reliable because they are not developed based on reliable assumptions.

(Researcher's Record)

Most of the informants agreed that SMEs are unable to produce reports such as monthly, quarterly financial statements. One of informant opinion was:

Most of the time banks request monthly quarterly financial statements but SMEs are unable to provide them. If they provide them they are less reliable due to certain window dressing activities.

(Researcher's Record)

Most of the informant agreed that there is a report expectation gap between financial intermediaries and SMEs. Moreover they concluded that SMEs are needed greater

Table 4: Financial information requirements of financial intermediaries

	N	Mean
Financial Intermediaries play a significant role by providing loans for SMEs	15	1.3333
Providing financial information in a standard manner is having importance	15	1.7333
we request profit and loss account	15	1.5333
We request cash and other budgetary reports	15	1.8000
We request cash flow statement	15	1.8667
We request all three above statements simultaneously	15	2.2667
SMEs must adopt a better reporting practice	15	1.6667
Valid N (list wise)	15	

improvement regarding financial reporting practices.

### 4.3 THE FINANCIAL INFORMATION GAP

The hypothesis of the study is tested using the One Sample T Test and analyze the variable on its own. Thus the one sample t test is selected to analyze the data gathered. According to the hypothesis mentioned above the following null and alternative hypotheses can be devised. The null hypothesis is;

H<sub>0</sub>: There is no a financial information gap between financial intermediaries and SMEs.

Thus the alternative hypothesis is;

H<sub>1</sub>: There is a financial information gap between financial intermediaries and SMEs.

Table 5: Ranking financial information requirements of financial intermediaries

Type of Report	Mean	Rank
Profit / loss Account and Balance Sheet	1.533	1
Cash Flow Statement	1.8667	3
Cash and other Budgetary Reports	1.800	2
Above three Statements Simultaneously	2.2667	4

Source: Researcher's own construction

The Table 6 depicts the summary result of the one sample t test. The two tailed values are divided by 2 to convert in to a one tailed test. The hypothesis is tested individually for each question and takes the support of Table 4 for the data analysis. The significant value of .084 rejects the alternative hypothesis and accepts the null hypothesis. That is according to the SMEs point of view Financial intermediaries are more convenience way for financial facilities. Thus

there is not a financial information gap between SMEs and financial intermediaries.

The mean value of 1.333 in the Table 4 is also support this argument stating that the financial intermediaries are playing a significant role by providing financial facilities for SMEs.

The second significance value of 0.000 accepts the alternative hypothesis and rejects the null hypothesis at 99% confidence level. The mean value of 1.7333 in Table 4 is also support to this conclusion. That is both financial intermediaries and SMEs agree that providing financial information in a standard manner is having a very high importance when applying loan facilities.

The third and forth significance values of 0.000 and 0.000 is also support to accept the alternative hypothesis and reject the null hypothesis.

The last significance value of 0.001 is also accepting the alternative hypothesis and rejects the null hypothesis. The mean values of 2.6 and 1.667 are also support to the above conclusion stating that SMEs must adopt a better reporting practices and less quality reporting practices leads to ineffective decisions to support SMEs. In other words there is a financial information gap between these two parties.

### 5. CONCLUSION

The following conclusions can be drawn with the help of literature.

Marshall and Ketchum (1944) revealed that SMEs prepare profit and loss account, balance sheet as a routine. The findings of the resersher also suppor above liration. Whereas, the Cash Flow statement is not a popular report with SMEs. They have not a positive opinion about the production of Cash Flow statement.

Furthermore, Marshall and Ketchum (1944) concluded, that SMEs do not produce budgetary and variance analysis reports due to lack of knowledge and less future orientation. The researcher also found that budgetary reports are rare in SMEs due to various reasons. Whereas, SME owners believe that budgetary reports are having significance when applying loan facilities from financial intermediaries.

Edward and Peter (1994) revealed that the cash budget is a dominant request of most financial intermediaries. The researcher also supports to findings of Edward and Peter. Financial

Table 6: One sample *t* test results (Test value 3)

	<i>t</i>	Sg (1-tailed)
Banks are given priority and it is more convenience	-1.397	.084
Providing financial information in a standard manner is having significance	-15761	.000
It easy to provide requested financial information by banks	-4.381	.000
We need long period to produce financial information requested by banks	-3.375	.000
Banks always request to improve the quality of financial information	-3.175	.001

Source: researcher's own construction

intermediaries are given a higher priority to Cash and other budgetary reports to provide a sufficient amount of loan facilities to SMEs.

Berry (1987) remarked that SMEs' financial reporting practices are not reliable due to various impedes. Thus SMEs must improve their reporting practices to generate quality and reliable information. The researcher also found that the reliability and accuracy of financial reports of SMEs are less leading to loan evaluation process ineffective.

Binks (1990) remarked SMEs generate reliable information and financial intermediaries have to change the attitude towards SMEs. But Bink's argument is a contradictory argument to the researcher's findings.

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