Asymmetric Information and SME Financing: A case study of Homagama Divisional Secretariat.

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Introduction

It is evident that Small and Medium Enterprises play a vital role in the Sri Lankan economy contributing 52 – 53 per cent to Gross Domestic Production. Role of SME is considered as one of the major components in every developing as well as developed economy where it caters socio-economic strength to the country. SME sector enables the country's economy to be boot up as well as creates a huge amount of employment opportunities in the informal sector. Therefore SME can be taken as the backbone of the economy. When it comes financing aspect, financing on SME sector is vulnerable and widespread for many times. SMEs have their own complete information which will rarely be disclosed to another party. Lenders experience a great pain in providing credit facilities to this sector due to high transaction cost and recovery process occurred by asymmetry of information.

The main objective of this study is to find out how asymmetric information affect in SMEs financial access. It is further narrowed down into four such as understanding the financial reporting discipline of the entrepreneurs, observing why entrepreneurs are restricted produce their actual business status to lenders, identifying the main reasons which restrict SMEs to obtain external financial resources and examining bank strategies to handle asymmetric information issue.

Lenders such as banks and other financial institutes are restricted to grant credit facilities due to asymmetry of information. Lenders are exposed to a huge risk in funding while the entrepreneurs manipulate financial figures and provide false information. All these lead to adverse selection and moral hazard occurring immense contractions in the industry.

Literature review

Kitindi, Magembe and Sethibe (2007) argue that creditors, lenders and other bankers use financial information provided by enterprises. In this situation if the accuracy of the information is not entrusted the lenders will be mislead. Stiglitz and Weiss (1981) argue that agency problems such as asymmetry of information and moral hazard may impact on the ability to obtain the external sources of funds. Shinozaki (2012) argues that information asymmetry between borrowers and lenders increases the adverse selection and moral hazard risks for financial institutions. Mazani and Fatoki (2012) argue that asymmetry of information has become a major issue for lenders in credit rationing. Hong and Gu (2014) argue that asymmetry of information has made severe impacts on accessing external financial resources from formal financial industry.

2. Methodology

Sample and collection of data

Homagama Divisional Secretariat is in Colombo is consisting of 68 Grama Niladhari Divisions. The area is fully furnished with essential infrastructure. There are 254 small and medium scale enterprises established within the coverage of Homagama Divisional Secretariat. Randomly selected 75 SMEs were considered for the sample for SME sector and 4 banks were considered for the banking sector representing 2 from state sector and 2 from private sector. Data was collected using both primary and secondary methods. In this study the primary data is collected using two questionnaires; one is for SME firms and the other is for banks. Other than that interviews and field visits were made to assure the accuracy of the study. Collected data fed into the SPSS 17.0 to derive the set objectives. Likert Scale questions were used to test the respondents views are given a respective value. One –way Anova test is applied in this study. p – values is used to test hypothesis and the significance level of p – value is 0.05.

3. Results and discussion

It carries 66.67 per cent from manufacturing sector, 24 per cent from industrial sector and 9.33 percent from services sector. As a percentage 50.67 carry Sole proprietorships, 18.67 carry Partnerships, and 30.67 carry Limited Liability firms.

Referring to Table 1 analyzing the questionnaires given to SMEs it is arrived that p value is 0.602 which is above the standard p – value which shows SMEs are vulnerable to mislead lenders not declaring actual information.

Table 1 : SMEs mislead the lenders

Source	DF	Adj SS	Adj MS	F-Value	P-Value
Why - asymmetry	3	903.5	301.2	0.62	0.602
Error	71	34246.5	482.3		
Total	74	35150.0			

Model Summary

Source : Author's calculations

Referring to the Table 2 second objective p value is 0.327 means that SMEs faced difficulties in the event of getting credit facilities from banks.

Table 2 : Facing difficulties when information are asymmetric

Source	DF	Adj SS	Adj MS	F-Value	P-Value
Not declare- given facility	2	1075	537.5	1.14	0.327
Error	72	34075	473.3		
Total	74	35150			

Model Summary

Source : Author's calculation

Referring to the Table 3, when analyzing the questionnaires given to banks it is arrived that p-value is 0.225 ; it says that the bank are experienced in that their borrowers are avoiding reporting the accurate information to their borrowers.

Table 3 : Bank experience in asymmetric information provided by borrowers

Source	DF	Adj SS	Adj MS	F-Value	P-Value
Purposely avoid	1	3.000	3.000	3.00	0.225
Error	2	2.000	1.000		
Total	3	5.000			

It is proven that there are co-relationship with asymmetric information. Similarly, the first, second and third objectives were addressed by the p and ANOVA test. Percentage calculation of regular financial behaviour gives a clear picture of their accounting practices.

4. Conclusion and policy recommendations

Conclusion

Majority sole proprietors (55.27 per cent) and partnerships (64.29 per cent) do not maintain audited financial statements. All limited liability firms maintain audited financial statements. Higher information asymmetry can be observed among sole proprietorships and least asymmetry of information is granted to limited liability firms.

Lack of knowledge in financial reporting, less awareness about how it is needed by lenders to take credit decisions., heavy work load in the business operational activities and banks always prefer favourable financial positions before lending caused for asymmetric information.

Banks demand for financial reports, do regular customer, call for other bank status reports, review CRIB reports to evaluate the direct and indirect liabilities., release funds stages by stages observing utilization and obtain a fixed property security to mitigate the credit risk (as a secondary option)

Policy recommendation

The study focused to examine the financial reporting behaviour of SMEs, why SMEs are far distant from formal financial industry, why SMEs are facing difficulties in getting loan from banks and how do banks manage the problem of asymmetric information while evaluating credit proposals.

Form a unique definition for SMEs in the country is stressed out since different institutions have formed different definitions depending on their institutional goals and they are conflicting with each other.

Formalizing the sole proprietors and partnerships is an essential fact to be considered since majority of them avoid maintaining proper financial discipline. Informality of the management and tax evasion have caused for that. Therefore these firms should be streamed line into formal financial discipline.

Banks heavily depend on CRIB report however pawning facilities obtained by borrowers are not traced by them, yet a matter to be considered for the credibility of the borrower. Status of the pawing facilities must be included in the CRIB under the borrower's identification number which enables the lender to evaluate the total debt of the borrower.

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