

# Determinant of Profitability of SMEs in Nigeria (A Study of Ogun State)

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Oluwakayode David Oke & Margaret Adebimpe Oke

## **Abstract**

The research work empirically investigated the determinant of profitability of small and medium enterprises in Nigeria. The study aimed to identify the determinant of SMEs in Nigeria. The study relied on primary source of data collection for its analysis. All the data had been derived from the primary source/field survey using a well-constructed questionnaire which was distributed to different small scale enterprises in Ogun State. Data generated from returned questionnaire were presented using tables, analysed using percentages and interpreted below each table. The hypothesis formulated was tested using chi-square. SPSS was used to analyze information gotten from the questionnaire. The results demonstrated that there was interdependence between the SMEs profitability and bank loans, and a significant relationship between profitability and the size of business. For high profitability, increased loans and growth in size of business remain important. The study however recommended that the government should formulate policies that will compel commercial banks to relax their restrictive regulations and operations which discourage borrowing, and offer more credit facilities for SMEs. Finally, the government should empower the SMEs to access and get credits from the commercial banks through formal and informal entrepreneurship education.

*Keywords: .SME .Profit .GDP .Credit facilities .Business*

## **Introduction**

Policy-makers all over the world have shown a keen interest in the subject of Small and Medium Enterprises (SMEs). This can be explained by both the contribution that SMEs make to the private sector and the common perception that SMEs are credit constrained. These are significant factors for African economies where SMEs account for close to 50 per cent of employment. Furthermore, enterprise surveys conducted by the World Bank reveal that close to 40 percent of small firms and 30 percent of medium-sized firms perceive access to finance as a major stumbling block to the growth of their operations thereby affecting their profitability.

Economies of the world, both developed and developing, have also come to realize the value of small and medium scale business in their development process. These enterprises are seen to be characterized by dynamism, innovations and efficiency. Even their small size allows for faster decision-making process. Governments all over the world have realized the importance of this category of businesses and have formulated comprehensive public policies to encourage, support and fund their establishment. Until the early 1960s, many economists viewed the continued existence of small-scale industries in less developed countries as justified by scarcity of capital and administrative experience. It was often argued that with economic growth, the small, traditional type of enterprise would, in one sector after another, be superseded by modern forms of large-scale production. In order to ensure an orderly transition, small industries were seen to

deserve support, but mainly in sectors where modern methods could not be immediately applied.

Several roles played by small scale and medium scale business, notwithstanding its development, is constrained by inadequate funding and poor management. Unfavorable macro economic environment has also been identified as the major constraint which most of times discourage financial institutions to fund small and medium enterprises. This can be explained by information asymmetry that often exists between small scale business and lending institutions. In Nigeria the full potential of the small and medium enterprises has not yet been tapped due to the existence of the constraints which includes undeveloped infrastructure as well as poorly coordinated institutional support framework. Recognizing the importance of SMEs in economic development, government in Nigeria has set up various programmes and institutions aimed at developing the SME sector. However, SMEs are vulnerable and very few manage to survive due to the problems of finance, low sales, low profitability, high costs of doing business and labour market barriers. Since the attainment of independence in Nigeria every regime recognized the importance of promoting small and medium enterprises as a unique basis for economic growth. As a result, several micro lending institutions were established to enhance the development of small and medium enterprises. Unfortunately, records indicate that the performance of SMEs in Nigeria has not justified the establishment of this plethora of credit institution. Odedokun (2005) noted that, in spite of the quantum of credit made available to the sector; the contribution of the index of small and medium enterprises to GDP was only 13 percent between 1999 and 2004.

Given the great potential of small and medium sized enterprises to bringing about social and economic development, it is no surprising that the performance of SMEs is of great concern to the government of different countries of the world, without the exemption of Nigeria. Small and medium scale enterprises, in both developing and developed countries, plays important roles in the process of industrialization and economic growth, by significantly contributing to employment generation, income generation and catalyzing development in urban and rural areas (Olutunla, 2001). The financial systems in every country play a key role in the development and growth of the economy, although the ability to play this role effectively and efficiently largely depends on the degree of development of the financial system and the traditional commercial banks which are key players in the financial systems of nearly every economy, have the potential to pull financial resources together to meet the credit needs of SMEs. However, there is still a huge gap between supply capabilities of the banks and the demanding needs of SMEs in Nigeria (Olutunla and Obamuyi, 2008).

Therefore, due to increasing competitive pressure and reduction of the direct subsidies and protection they formerly received from their governments, it is particularly necessary for SMEs in developing countries to internationalize. This is with the sole aim of enhancing their profitability, as it is no hidden fact that profit is the intending expectation of any business and that any organization which intends to survive must maximize profit on the long run in order to have enough stands to carry out its activities. This study will examine survey data in order to evaluate the characteristics of SMEs that make it more difficult for them to be profitable and the particular problems that they face which may have contributed to their poor performance in order to identify the major determinant of profitability of SMEs in Nigeria.

#### **Review of Relevant Literature**

Nnanna (2001) stated that small and medium scale enterprises needs funds to bring together the other factors of production- land, labour and capital for production to take place. Unfortunately small and medium scale enterprises have been discriminated against by financial institutions because of the high risk associated with financing them. Access to economic sources of finance for small and medium scale enterprises has, therefore, been a

major issue in literature of economic and industrial development. Sule (1986) stated that, it is evidence around the world that small and medium scale enterprises provide an effective means of stimulating indigenous entrepreneurship, enhancing greater employment opportunities per unit of capital invested and aiding the development of local technology. While reflecting the global trend in “downsizing of enterprises” multinational enterprises have continued to shift that focus of activity away from the giant vertically integrated corporations which dominated productive activities in the 1950s and 1960s towards small industries to gain competitive advantage.

Nnanna (2003) acknowledged that, small and medium scale enterprises are considered generally as the bedrock of the industrial development of any country. Apart from the numerous goods produced by SMES, they provide veritable means of large scale employment, as they are usually labour intensive.

Adelaja (2003) argued that, “there is a critical need to re-orientate our people” to switch to buying made in Nigeria goods because “Nigeria has become a dumping ground in virtually everything”. One of the envisaged problems by the banks is lack of savings, capital formation and direct foreign investment, which may make the possibility of exit via buyouts by the strategic and/or financial investors very slim. These challenges have resulted in banks having greater difficulty in serving SMEs or even identifying fundable ones. Such difficulties severely limit the amount of equity funds available to SMEs in Nigeria. This could be seen from the small amount already disbursed from the pool of the fund set aside by the banks. By the end of the year 2003, a sum of N19.72 billion had been pooled by 84 banks under the SMIEIS, while only N7.07 billion (about 36 percent) had been invested in 137 projects across the country by 44 banks (about 52 percent) (CBN, 2004)

The World Bank survey on access to finance of Nigerian firms has demonstrated that most banks are reluctant to provide long-term credit to small and medium scale industries in Nigeria. It is also obvious from the survey that even when banks extend short-term credit to small and medium scale firms it is often based on high collateral requirements and the facilities do not go beyond a one-year term. This behaviour is akin to risk aversion. A bank is risk-averse when it considers the expected value of returns on an investment as being less than the expected utility of the investment outlay. SMEs in Nigeria lack access to finance, perhaps the most visible of all the growth constraints. Little wonder why most efforts on the part of the Nigerian government seem to have been focused on this constraint. A major reason why funds flow into this sector has been slow because of the perceived high risk of the sector. For the SMEs that do have access, the rate is unusually too high. Consequently, unless the SMEs are involved in distribution trade, there is no way they can meet their obligations to the lending institutions. Unfortunately, there is a major mismatch in the nature of funds available (mostly short-term) compared to the nature of funds required by the productive sector (medium to long term). In an effort to resolve this, the bankers committee (with the encouragement of the federal government) commenced the small and medium equity investment scheme (SMEIS) initiative aimed at solving the long term capital needs of SMEs. Microfinance is a term describing small savings and loans institutions or programs. Although the poor could benefit greatly from savings, investment and loans, they often have no access to financial markets because they lack credit and collateral.

De Soto (2000) argues that the poor are asset rich, but lack the means to convert these assets into investment and capital because of their inability to access the credit market. The problem may be that although the poor demand financial goods, there is a lack of supply for them (Hulme, 2000). MFIs propose to bridge the gap and provide the poor with small loans and savings. It is important to gain unbiased information about the impacts of microfinance considering the great amount of money and hope that depends on the success of these programs. The major criticism of microfinance has been that it has not reached the very poor, and that the participants of the programs who benefit the most

are those who already were well-off or had the entrepreneurial spirit to succeed without the MFI loans. Hulme and Mosley (1998) found that there is an "impact frontier" where MFIs must choose between targeting the poorest of the poor and achieving a very small impact or targeting those closer to the poverty line and seeing a big impact.

Zaman (2000) reports a similar result in his study where participants that have above a threshold of loans over 10,000 naira, about 100 dollars, felt the greatest impact. Since the very poor are not able to reach this threshold, they do not see as large of a positive impact as other participants in the program. Although the results of these studies are important, they all find that there are some gains for the majority of participants in the programs. A more important concern is the criticism that the very poor do not participate in these programs at all. Coleman (2002) found that the wealthiest villagers were twice as likely to participate in MFIs. In village banking systems they were more likely to get controlling program committee positions. Managers of MFIs may also have incentives to avoid the very poor since their goals are to be sustainable, and the poor are more costly to serve than those nearer to the poverty line (Murdoch and Armendariaz 2005). These studies argue that those that participate are more likely to be the already successful or motivated in the community, and thus microfinance is not reaching those who need the help most. Zohir and Matin (2004) developed a theory that microfinance can have spillover effects to many aspects of the community such as transportation and health.

Mushtaque, Chowdhury and Mosley (2004) suggest that MFIs have broad impacts like stabilizing volatile financial sectors, using derived demand to increase employment, and providing institutional inspiration. The experience of micro-finance lending in Nigeria had not been quite successful from the formal model approach. Inadequate information will preclude making a categorical statement of the success of informal model. However, most poor groups seem to appreciate informal lending. In order that the proposed model where we have linked institution to purvey credit work successfully, the following principles should be considered to avoid the pitfall of the past institutions: (i) Simplify services, (ii) Offer small initial loans, (iii) Offer short term loans, (iv) Localize services, focus on scale, (v) Shorten turn around time, (vi) Motivate repayment, (vii) Recognize that the poor do save, (viii) Charge full-cost interest rates (factoring in inflation, loan losses and delinquency and the cost of loan funds).

### **Theoretical Framework**

This assumption is not farfetched when it comes to the analysis of the relationship between saving and investment. Giving the fact that sourcing for fund for small scale enterprises is a very difficult task and that individual are incapacitated to set up such business due to lack of fund which invariably hinder the level of their profit, then there is need to theoretically examine the determinant of profitability of these SMEs and the source of fund being invested in the business since it has been one of the means of employment generation and raising the standard of living of the citizen as a result of the downward trend in the Global economy and the high rate of unemployment in the developing countries.

All economists believe in the equality of saving and investing (Jhigan, 2004) but they differ as to the manner in which this equally is brought about.

#### *The Classical View*

The classicists believe in the existence of fully employed economy where saving and investment are always equal, which make saving and investment the function of interest rate.

$$\text{i.e } S = f(r) \text{ and } I = f(r)$$

Therefore  $S = I$

They argued that when interest rate rise saving also rises and investment fall. On the other hand, when interest rate fall saving also falls and investment rises.

*The Keynesian View*

There are two views with regard to the saving-investment equally as put forth by Keynes. These are:

a. Accounting or Definitional equality: This tells us that actual saving and actual investment are always equal all time and at any level of income. In order to show this, they defined saving and investment in such a manner so as to establish their equality. Both saving and investment in the current period are defined as the excess of current income over current consumption ( $Y_t - C_t$ ) so they are necessarily equal.

$$S_t = Y_t - C_t \dots\dots\dots I$$

$$I_t = Y_t - C_t \dots\dots\dots II$$

Since  $Y_t - C_t$  is common to both equations

$$\text{Then } S_t = I_t \dots\dots\dots$$

Where S is saving, I is Investment, Y is income, C is consumption and t is current period

b. Functional equality. This stipulates that saving and investment are equal only at the equilibrium level of income, i.e. saving and investments are not only equal but also in equilibrium. This is brought about by the adjusting mechanism of income as distinct from the classical view of variations in the rate of interest. Here, income is functionally related to saving and investment. When saving is more than investment income falls and when investment is more than saving income rises this dynamic process will continue till saving and investment are equal but are also in equilibrium. This is illustrated below:

Income	saving	Investment	Income movement
100		-15	10
200		0	20
300		15	30
400		30	40
500		45	50
600		60	60
700		75	70
800		90	80
900		105	90

Expansion  
Equilibrium  
Contraction

*Saving - Investment Equality*

So long as investment is greater than saving, income continues to increase till it reaches the equilibrium level of 600 where saving and investment equal to 60 each. Beyond this point, saving exceeds investment and the equilibrium is reached when income contracts.

*Harrod - Domar Model*

Harrod and Domar assign a key role to investment in the process of economic growth, being one of the major goals of macroeconomic policy of modern government. But they lay emphasis on the dual character of investment. Firstly, it creates income (i.e. demand effect of investment), and secondly, it augments the production capacity of the economic by increasing its capital stock (supply effect of investment). Hence, so long as net investment is taking place real income and output will continue to expand. However, to maintain a full employment equilibrium level of income from year to year, it is necessary that both real income and output should expand at the same rate at which the productive capacity of the stock is expanding. The divergence between the two will lead to excess or idle capacity, thus forcing entrepreneurs to curtail their investment expenditures.

Since it has been highly observed that accumulated saving of individual become a strong capital base for entrepreneur investment, then there is a close link between saving, investment and economic growth.

Harrod and Domar worked on the influence of money on economic growth within the context of the classical thesis of:

- a) Price Flexibility
- b) Full employment.

They argued that economic growth depends on savings and capital output ration.

$$g = s/v \dots\dots\dots (1)$$

**Research Design**

This research study used primary data, which are collected from selected small-scale businesses in Ogun State.

**Materials and Method**

The study was conducted in Ogun State of Nigeria, being a typical State in terms of the characteristics of SMEs in Nigeria, availability of physical and financial infrastructure as well as economic resources. Two methods were used to identify the SMEs, since no comprehensive listing of SMEs is available in the state. First, listing of firms from the Ogun State Board of Internal Revenue tax reports was used to identify the names and addresses of SMEs. Second, the names and addresses of SMEs were obtained from the listing at the Ogun Ministry of Commerce and Industry, Abeokuta. The SMEs selected for the sample met the Small and Medium Industries Equity Investment Scheme's (SMIEIS) definition for SMEs of having 10 - 300 workers. A comprehensive structured questionnaire is developed to collect data from the firms on the amount of loans, sales, level of profit, size of business (measured by the number of employees) and business age (measured by the number of year of the business existence).

**Techniques for Data Analysis**

Analysis means the ordering, categories manipulation and summary of data so that the research is self-explanatory. The purpose of analysis is to put data collection into manageable and intelligible form for the relation of the research problem to be studied and tested. The statistical analysis to be used includes; tables, percentage and chi-square analysis denoted by the symbol  $\chi^2$ . Oyesiku (2000) is of the opinion that chi-square ( $\chi^2$  test) is commonly used for comparison of frequency distributions. It is an important extension at hypothesis testing and it is used to test the goodness of fit that is to test whether there is any significant different between expected and observation frequency and also, to test whether two variables are independent of one another.

**Data Source and Method of Data Analysis**

The primary data used in testing the research hypotheses of this research work is sourced for using a well-constructed questionnaire. The instrument (questionnaire) consists of two sections. The first is the personnel data of the respondent, while the other sector deals with question relating to the topic under research. The responses were ranked 4,3,2,1 depending on the option. The level of perception of each respondent was obtained by adding the score of the responses. The data obtained was analysed using frequency count, percentage and tables.

**Data Analysis**

On the whole, the total numbers of Ninety (90) questionnaires were administered to various strata of respondent as indicated in the previous chapter. Out of which 75 representing 83.3% of the whole questionnaire were returned. The remaining was not returned for the reasons which include loss of questionnaire, inability to locate recipients among other. The returned and accepted questionnaires were presented, analyzed and measured for hypothesis testing, using SPSS.

**Test of Hypothesis**

YEAR OF EXISTENCE

O	E	O-E	(O-E) <sup>2</sup>	(O-E) <sup>2</sup> /E
20	25	-5	25	1
34	25	9	81	3.24
21	25	-4	16	0.64
				4.88

$\chi^2_c = 4.88$

Critical region =  $\chi^2_t = 5.99$

Hence  $\chi^2_c > \chi^2_t$  i.e.  $4.88 < 5.99$

Degree of freedom =  $n-1=3-1=2$

Decision:

Therefore,  $H_0$  will be accepted and  $H_1$  rejected that year of existence of business as profitability determinants have no significant effect on SMEs performance in Nigeria.

LOAN

O	E	O-E	(O-E) <sup>2</sup>	(O-E) <sup>2</sup> /E
22	25	-3	9	0.36
30	25	5	25	1
23	25	-2	4	0.16
				1.52

$\chi^2_c = 1.52$

Critical region =  $\chi^2_t = 5.99$

Hence  $\chi^2_c < \chi^2_t$  i.e.  $1.52 < 5.99$

Decision:

Therefore,  $H_1$  will be rejected and  $H_0$  accepted that loan as profitability determinants have no significant effect on o SMEs performance in Nigeria.

NUMBER OF EMPLOYEE

O	E	O-E	(O-E) <sup>2</sup>	(O-E) <sup>2</sup> /E
48	25	23	529	21.16
17	25	-8	64	2.56
10	25	-15	225	9
				32.72

$\chi^2_c = 32.72$

Critical region =  $\chi^2_t = 5.99$

Hence  $\chi^2_c > \chi^2_t$  i.e.  $32.72 > 5.99$

Decision:

Therefore,  $H_0$  will be rejected and  $H_1$  will be accepted that number of employee (size of business) as profitability determinants have significant effect on SMEs performance in Nigeria.

SALES VOLUME

O	E	O-E	(O-E) <sup>2</sup>	(O-E) <sup>2</sup> /E
47	25	22	484	19.36
17	25	-8	64	2.56
11	25	-14	196	7.84
				29.76

$\chi^2_c = 29.76$

Critical region =  $\chi^2_t = 5.99$

Hence  $\chi^2_c > \chi^2_t$  i.e.  $29.76 > 5.99$

Decision:

Therefore,  $H_0$  will be rejected and  $H_1$  accepted that sales volume as profitability determinants have significant effect on of SMEs performance in Nigeria.

INTEREST RATE

O	E	O-E	(O-E) <sup>2</sup>	(O-E) <sup>2</sup> /E
25	25	0	0	0
27	25	2	4	0.16
23	25	-2	4	0.16
				0.32

$\chi^2_c = 0.32$

Critical region =  $\chi^2_t = 5.99$

Hence  $\chi^2_c < \chi^2_t$  i.e.  $0.32 < 5.99$

Decision:

Therefore,  $H_1$  will be rejected and  $H_0$  accepted that rate of interest as profitability determinants have no significant effect on of SMEs performance in Nigeria.

**Summary of the Major Findings**

The major objective of this study is to examine the determinant of profitability of SMEs in Nigeria. This study explores the contributions of small businesses to affect the reduction of unemployment in Nigeria. It also touches some of the problems that are hindering the sustainability of small business enterprises in Nigeria. Mainly, primary data that was used for the analysis was collected using a well-structured questionnaire. SPSS was adopted for the analysis of the data. This complements the use of table and percentage.

Knowing the problems relating to establishing a small business in Nigeria is good for all business investors and aspiring entrepreneurs. Establishing a small business in Nigeria has its problems and prospects, like many other countries around the world. Lots of information and research needs to be done before establishing a business. Various theories relating to the research were also examined.

Nigeria is a developing country with a population of about one hundred and sixty million, need to get the small business owners or entrepreneurs informed so that they can get their businesses going and avoid major or long term problems to boost the country's economy. If there are no problems there will not be solutions but if Nigerian small business owners are aware of the possible problems that may occur in running their business, it will anchor taking careful measures, also finding the right information or being well informed before establishing a small business in Nigeria will go a long way. The study reveal that loan and interest rate have no significant effect on the performance of SMEs in Nigeria, judging from the result of the chi-square calculated when compared with the critical value at 5% level of significance. Of the entire variables considered as the determinant of profitability of SMEs, only age of business, number of employee and sales volume has effect of the performance of SMEs in Nigeria as reveal in the analysis.

**Conclusion**

The study has contributed to our knowledge on the series of factors associated with the profitability of small and medium-sized firms in Nigeria. The results demonstrate that there is interdependence between the SMEs profitability and bank loans, a significant relationship between profitability and the size of business and a negative relationship between profitability and interest rate based on the respective percentage of the respondents. For high profitability, more loans and growth in size of business remain important likewise the sales volume, size of business and age of business.

**Recommendations**

Judging from the finding and the conclusion of this study, it is however recommended that:

- a. Government should re-introduce and enforce the mandatory minimum credit allocation by banks to SMEs in the Annual Monetary Policy Circular and Guidelines.

- b. Government should formulate policies that will compel commercial banks to relax their restrictive regulations and operations which discourage borrowing and offer more credit facilities for SMEs.
- c. That most business owners must be advised and encouraged to apply for credits - such as goods and services as this not really require that one must be highly education. Banks should be willing to listen to these owners and to grant their request if they meet the required criteria.
- d. The Government should re-introduce and enforce the mandatory minimum credit allocation by banks to SMEs in the Annual Monetary Policy Circular and Guidelines.
- e. The findings of this research implies that government should formulate policies that will compel commercial banks to relax their restrictive regulations and operations which discourage borrowing and offer more credit facilities for SMEs.

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OKE, OLUWAKAYODE DAVID is a lecturer with the Department of Accounting and Finance, Samuel Adegboyega University, Ogwa, Edo State, Nigeria. E-mail: odavidking@gmail.com, ooke@sau.edu.com Phone: +23480789191, +2348022282329

OKE, MARGARET ADEBIMPE is a lecturer with the Department of Economics, Ajayi Crowther University, Oyo, Oyo State, Nigeria. E-mail: oke\_margaret@yahoo.co.uk Phone: +23408063123322, +2348055201747