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FINANCING OPTIONS FOR SMALL AND MEDIUM ENTERPRISES (SMEs) IN NIGERIA

E. C. Gbandi, PhD
Department of Business Administration,
Benson Idahosa University, Benin City, Nigeria
G. Amissah, PhD
Department of Business Administration,
Wellspring University, Benin City, Nigeria

Abstract

Small and Medium enterprises act as catalysts in the economic development of the developed and developing countries. Developing countries like Nigeria that require sustained economic growth in their economies must pay attention to the SME sector and harness the great potential to generate employment, improved local technology, output diversification, developed indigenous entrepreneurship and forward integration with large-scale industries that can be provided by the sector. Unfortunately, the SMEs in Nigeria have underperformed despite the fact that the SMEs in Nigeria constitute more than 90% of Nigerian businesses, their contribution to the nation's GDP is below 10%. This very low percentage contribution of the SMEs to Nigeria's GDP could be attributed to amongst others; unfriendly business environment, poor funding, low management skills and lack of assess to modern technology. However, this paper focuses on adequate funding which will take care of some of the problems such as provision of modern technology and low managerial skills. It examines the financing of SMEs in Nigeria and the various financing options available to the SMEs. This involved looking at debt financing by considering the role commercial, microfinance banks, co-operatives and other finance institutions play in the financing of SMEs in Nigeria. It also considered the role of equity financing through Venture capital and Business angels financing. It concluded that funding of SMEs in Nigeria is very critical if they are to perform their role of growth and development of the nation's economy.

Keywords: Financing Options, SMEs, Venture Capital, Business Angels

Introduction

Small and Medium Enterprises, (SMES) are very critical to the development of any economy. The important role of SMEs to the development of the economy of any nation is even more evident when the economies of developing nations are considered. The SMEs have played very important roles in the development of many Asian countries and indeed the Asian giants. The economic boom in some of these Asian countries which is not unconnected to SMEs have lifted hundreds of millions of people out of poverty and created tens of millions of new middle-class consumers (Tanzer, 2005). SMEs are responsible for driving innovation and competition in many economies. In India, the SMEs account for about 39% of manufacturing output and 33% of total exports. SMEs possess great potential for employment generation, improvement of local technology, output diversification, development of indigenous entrepreneurship and forward integration with large scale industries (CBN, 2011). The major questions to be asked about SMEs in Nigeria are: what has been the role of the SMEs to the economic development of Nigeria? and what is the contribution of the SMEs to the manufacturing output and total export in Nigeria?. Evidence has shown that SMEs in Nigeria have underperformed and have not made significant contribution to the nation's economic growth and development. The key issues affecting the SMEs in Nigeria can be grouped into four namely; unfriendly business environment, poor funding, low managerial skills and lack of access to modern technology (FSS 2020, SME sector Report, 2007). Lack of access to modern technology and low managerial skills (which may be due to lack of funds to acquire relevant technology and hire skilled staff) can be checked if the SMEs are properly funded. Financing of SMEs in Nigeria is therefore very critical if they are to perform the growth and developmental role in the nation's economy. Proper financing of SMEs in is an essential tool for promoting and leveraging small and medium enterprises development in Nigeria. The question here is, what are the financing options for SMEs in Nigeria? Various policies put in place have targeted both financial and non-financial institutions. Some of these financial institutions include the CBN, commercial banks, microfinance banks, international development agencies, like the African development bank, etc.

This paper focuses on financing SMEs in Nigeria. It examines the various financing options available to the SMEs. It also discusses the constraints for financing SMEs and innovations designed to overcome these constraints.

SMEs in Nigeria

Small and medium enterprises are a very important part of the Nigerian economy as a study by the IFC show that approximately 96% of

Nigerian businesses are SMEs (Oyelarin-Oyeyinka 2010). The SMEs represent about 90% of manufacturing/industrial sector in terms of number of enterprises in Nigeria. However, in spite of the fact that the SMEs constitute more than 90% of Nigerian businesses, their contribution to GDP is only about 1%

The definition or classification of small and medium enterprises differs from country to country. There is no generally accepted definition or classification of SMEs. Different authors, scholars and schools have different ideas as to differences in terms of capital out lay, number of employees, sales turnover, fixed capital investment, available plant and machinery, market share and the level of development (ogechukwu, 2009). In countries like the USA, Britain and other European countries, Small and medium scale enterprises are defined in terms of turnover and number of employees.

The definition and classification of SMEs in Nigeria is in terms of capital employed, turnover and number of employees. The CBN communiqué No 69 of the special monetary policy committee meeting of April 15, 2010 acknowledged the existence of several definitions of SMEs. One of such definition/classification states that an enterprise that has an asset base (excluding land) of between N5 million to N500 million and labour force of between 11 and 300 belongs to the SME sub-sector. This definition is what the Small and Medium Enterprises Credit Guarantee Scheme (SMECGS) adopted. SMEs have also been broadly defined as businesses with turnover of less than N100million, for the Small and Medium Enterprises Equity Investment Scheme (SMEEIS), a small and medium enterprise is defined as any enterprise with a maximum asset base of N1.5 billion (excluding land and working capital) with no lower or upper limit of staff. Some of the criteria used in classifying SMEs in other countries are tabulated in Table 1 below:

Table 1

COUNTRY	TURNOVER	TOTAL INV.	NO. OF EMPLOYEES
UK	GBP200million		200
JAPAN(TRADE)	Yen 30million		100
JAPAN(industrial)	Yen 100million		300
NIGERIA(1988)	N5.0 million	N0.5million	200
NIGERIA (1990)	N25 million	N5.0million	300

Source: CBN 1988 MONETARY CIRCULAR 22

As a result of the definitional differences of SMEs across countries and the absence of a universal definition, the European Union in 2003 adopted a universally accepted definition of small and medium scale enterprises and micro business as companies with less than 250 employees, revenues must not exceed 50million euro (turnover) or 43million euro (Fatai, 2011).

In Nigeria, SMEs are distributed by clusters within regions. You have the Aba leather and the fashion SMEs clusters, Nnewi has the automobile SMEs cluster, Lagos has the Otigba ICT SMEs cluster, Abeokuta and Oshogbo the tie and dye SMEs clusters and Kano has the leather SMEs clusters (Oyelarin-Oyeyinka, 2010).

There is no reliable database on SMEs in Nigeria and so it is difficult to accurately determine the number of SMEs in Nigeria. However, the Small and Medium Enterprises Development Agency of Nigeria (SMEDAN) using data collected from the National Bureau of Statistics (NBS) is working on the publication of its first comprehensive database of small businesses in Nigeria (leadership newspaper 05/03/2012).

A recent survey conducted by the national bureau of statistics indicate that Anambra state has the highest number of SMEs in Nigeria (vanguard Newspaper, 2012) and they also led in four industrial sectors including the automobile sector.

Financing Options of SMEs in Nigeria

It is generally accepted by both the practitioners and academicians that SMEs serve as catalysts for the economic growth of the economy of any nation. However, the SMEs are faced with many challenges. In Nigeria, one of the major challenges faced by SMEs is that of capital to finance their operations (Fatai, 2009). Empirical evidence shows that finance contributes about 25% to the success of SMEs. (Ogujuiba, et al 2004). A World Bank report showed that 39% of small scale firms and 37% of medium scale firms in Nigeria are financially constrained. (World Bank report, 2001). Many SMEs in Nigeria lack the capital to continue their business and they are forced to close shop because they are unable to access the required funds. What are therefore, the financing options of SMEs in Nigeria?

Every enterprise is financed either through debt or equity or a combination of both. Both types of financing are usually sourced from either the informal finance sector (IFS) or the formal finance sector (FFS). The two fundamental financing concepts of SMEs, the formal and informal forms of financing, have been identified by previous researchers, scholars and practitioners (Gelinas, 1998; Aruwa, 2004). The researchers identified commercial banks and development banks in the formal sector as the most popular source of finance for enterprises. The informal sector which consists of borrowing from friends, relatives and cooperatives are also important source of financing SMEs. Another source of enterprise financing is through personal savings.

The informal finance sector consists of informal finance institutions like money lenders, landlords, friends, relations, credit and savings associations (co-operative societies), esusu, also known as ayo among the

Yorubas, isusu or atu among the Ibos, osusu among the Edos, adashi among the Hausas, dashi among the Nupes and etibe among the Ibibios. (Okorie & Miller, 1976). The formal finance sector is made up of formal finance institutions such as commercial banks, microfinance banks, international development agencies etc.

Financing SMEs by the formal finance sector FFS

Commercial banks, Microfinance banks, International development agencies, the CBN and some of its agencies and some of its agencies are some of the institutions in the formal finance sector that have played very prominent roles in the financing of SMEs in Nigeria. Commercial banks remain the biggest source of finance for SMEs across the globe. However many commercial banks are reluctant in financing SMEs because of perceived risks and uncertainties. In Nigeria the difficult economic environment, absence of the appropriate managerial skills and lack of access to modern technology by the SMEs have all contributed to the commercial banks reluctance to finance the sub-sector. The result of this reluctance is the steady decline in financing of SMEs in the country over the years. The CBN (2010) statistics show that commercial banks advances to SMEs have been on the decline over the years. Commercial bank loans to SMEs as a percentage of total credits decreased from 48.79% in 1992 to 0.15% in 2010 (Luper, 2012).

Similarly, merchant banks loans to SMEs as a percentage of total credits reduced from 31.2% in 1992 to 9.0% in 2000 (Achua, 2011). Many credit institutions have been established over the years by the government and its agencies. The objectives of these credit institutions have always been to improve access to finance by SMEs. Some of these institutions are the Nigerian bank for commerce and industry (NBCI), National economic reconstruction fund (NERFUND), the Peoples bank of Nigeria (PBN) which has been referred to as government social lending, the community banks (CB) now microfinance banks, Nigerian export and import bank (NEXIM), and the Nigerian agricultural credit guarantee scheme. Others are the Small and Medium equity investment scheme (SMEEIS) which was actually a voluntary initiative in 1999 by the bankers' committee through CBNS' moral suasion, to assist in providing finance to the small enterprises, the small and medium enterprises credit guarantee scheme (SMECGS). In the 1980s, banks were mandated to set up branches in the rural areas. The objective of this policy was to improve access to financial services (Soludo, 2008).

Small and Medium Enterprises Credit Guarantee Scheme (SMECGS)

The Central Bank as part of its developmental role established the scheme for promoting access to credit by SMEs in Nigeria. The scheme has a fund of N200 billion (two hundred billion Naira) wholly financed by CBN. One of the schemes is to fast track the development of the manufacturing SME sector of the Nigerian economy by providing guarantee for credit from banks to SMEs and manufacturers. Activities to be covered under the scheme include;

(a) Manufacturing
(b) Agricultural value chain
(c) Educational institutions
(d) Any other activity as may be specified by the managing agent (CBN).

The credit facilities will essentially be for the following;

(i) Long term loan for acquisition of plants and machinery
(ii) Refinancing of existing loans
(iii) Resuscitation of ailing industries
(iv) Refinancing of existing lease
(v) Working capital

All deposit money banks (DMB) and development finance institutions are to participate in the scheme. The Bank of Industry (BOI) is the managing agent. The interest rate of 7% will apply to the loans, tenor is 15years. The scheme also makes provision for refinancing/restructuring facilities. The overall goal is to increase output, generate employment, diversify the revenue base, increase foreign exchange earnings and provide inputs for the industrial sector on a sustainable basis.

Small and Medium Enterprises equity Investment Scheme (SMEEIS)

This scheme is a voluntary initiative of the bankers' committee. The 246th meeting of the bankers' committee held in December 1999 approved the scheme. The initiative is in response to the Federal government concerns and policy measures for the promotion of Small and Medium Enterprises as vehicles for rapid industrialization, sustainable development, poverty alleviation and employment generation (CBN, 2012). The scheme requires all banks in Nigeria to set aside 10% of their profit after tax for investment and promotion of Small and Medium Enterprises. The scheme is essentially a pool for venture capital

The scheme covers every legal business activity except

a) Trading/merchandising
b) Financial services

The funds invested by participating banks shall be in the form of loans or equity investment or a combination of both in eligible enterprises. The interest on the loans shall be single digit subject to a maximum of 9% (CBN, 2012).

Banks shall remain equity partners in the business enterprises for a minimum of three years after which they may exit. Under the scheme, existing debts owed to participating banks may be converted to equity. As at June 2009, a total amount of N28, 204,078,746.00 had been set aside by the banks.

Agricultural Credit Guarantee Scheme Fund (ACGSF)

Despite the over 90% contribution of revenue from crude oil to the Nigerian economy, agriculture which was the mainstay of the economy before the discovery of oil will continue to be relevant to the nation. The agricultural sector has the capability of generating massive employment. In recognition of this, the agricultural credit guarantee scheme fund was set up in 1977 and it started operation in 1978 (CBN). Virtually all the farmers' societies, farmer groups and cooperatives will be categorized as SMEs. The fund guarantees credit facilities extended to farmers by banks up to 75% of the amount in default net of any security realized. The fund is managed by CBN.

Other agricultural credit schemes put in place by the Federal government and the Central bank of Nigeria are;

a). Agricultural credit support scheme (ACSS); the scheme is an initiative of the Federal government and the CBN with the active participation of the bankers' committee. It has a prescribed fund of N50 billion. The scheme has the objective of lowering the cost of agricultural production, generate surplus for export, increase Nigerians' foreign earnings as well as diversify its revenue base. ACSS are disbursed to farmers and agro-allied entrepreneurs at a single-digit rate of 8%.

b). Commercial agricultural credit scheme (CACS); the CBN in collaboration with the Federal Ministry of agriculture and water resources established the commercial agricultural credit scheme in 2009 to provide finance for the countries agricultural value chain (production, processing, storage and marketing). The scheme is financed through a N200 billion bond raised by the debt management office. Loans under this scheme are disbursed at a maximum rate of 9%.

Microfinance financing

The CBN recognized microfinance as an important tool for poverty alleviation through empowering the micro and small entrepreneurs (Olaitan, 2006). Most of the microfinance policies were targeted towards developing the agricultural sector of the economy. More than 60% of Nigerians, especially in the rural areas are engaged in agriculture and the informal sector. Microfinance financing of the agricultural sector was initiated by the Nigerian government through the CBN to improve the lot of the SMEs in this important sector of the economy.

Government policies for providing microfinance for the development of agriculture included;

- Commercial bill financing scheme (1962).
- Regional commodity boards (later called national commodity boards 1977).
- Export financing and discount facility (1977).
- Nigerian agricultural co-operative and rural development bank, NACRDB (1972).
- Community banks, now known as microfinance banks.
- Sectorial allocation of credit and concessional interest.
- Specified percentage of total deposits mobilized in the rural areas.
- Rural banking programme (1977).

Financing of SMEs by International development agencies

A member of the World Bank group, the International Finance Corporation, (IFC) has made significant contributions towards SME financing in Nigeria. In 2010, the IFC more than doubled its exposure to Nigerias' banking sector, investing almost $400 million of equity and loan financing in First bank of Nigeria (FBN), First city monument bank (FCMB) and GT bank (Omorogbe, 2011). The purpose of the new investment and advisory services of IFC was to help banks reach segments of the economy that needed better funding such as infrastructure and the SMEs. Specifically, FCMB received $70 million in November 2010 to help it increase financing of SMEs. The corporation is also working with the Department for International Development (DFID) to expand its funding and advisory role programs to Nigerian banks that have incorporated non-financial services to SMEs. In the words of IFC'S country Manager for Nigeria, Solomon Adegbie-Quaynor

> "Non-financial services such as management and advisory support help SMEs acquire the skills they need to grow. ICF is working with banks in Africa to help them deliver non-financial services, which in turn allows The banks to build a more loyal and diverse portfolio of small and medium Businesses." (Oladunjoye, 2012).

The African development bank (AFDB) is another international agency that plays a role in financing of SMEs not only in Nigeria, but in many other countries in Africa. The AFDB has approved a total of $700million worth of loan programs for Small and Medium sized Enterprises in Nigeria. (Mungcal, 2011). Another institution used by the AFDB in its effort to improve funding for SMEs is the African guarantee fund (AGF).

Venture Capital and business angels

Venture capital involves the provision of investment finance to private Small or Medium Enterprises in the form of equity or quasi-equity instrument not traded on the stock exchange. (Abereijo & Fayomi, 2005). Venture capital is also referred to as risk capital. Venture capital focuses on high growth business in early stages of development. The stages of venture capital are basically

a) seed capital

b) start-up and early stage capital

The venture capitalist may however provide funds for expansion and development, buyout etc. An empirical study "the effect of venture capital financing on the economic value added profile of Nigerian SMEs" (Dagogo & Ollor, 2012), found that venture backed SMEs contributed more to society in terms of taxes to government, provision for corporate social responsibility and staff welfare. The SMEEIS which is essentially a pool for venture capital has not done very well in terms of providing equity funds for the SMEs. Recently, two new sources of funds have been unlocked for investment in growth business in Nigeria through private equity and venture capital. They are the pension fund assets and sovereign wealth fund (SWF).

Pension reform act and SME financing

The pension reform act of 2004 established the compulsory Pension Scheme (CPS). The act has been largely adopted by the Federal government and the private sectors. However, only 17 out of the 36 state governments have passed bills to adopt and implement the CPS as at the end of 2010 (CBN). One of the duties of the National Pension Commission (Pencom) is the establishment of standards, rules and issuance of guidelines for the management and investment of pension funds under the act. Under the pension act, the funds may be invested in private equity funds and venture capital subject to a maximum of 5% of pension assets. The funds can also be invested in money market and equities. SMEs will benefit directly from pension funds investment in private equity funds. The pension asset funds were N2.029 trillion as the end of 2010. This means that more than N100 billion can be available for investment in private equity and venture capital. This amount will grow as pension funds grow by an estimated 20-30 percent per annum in the next few years (James, 2011).

Financing SMEs from IFS

The sources of investment finance for SMEs include owner's savings local authorities, moneylenders and other sources of finance from the informal financing sector. In a study by Ojo(1984), funds from personal savings was 96.4%, 3% from informal sector and only 0.21% from the formal finance institutions. This trend is in agreement with a 1983/84 study by the Nigerian institute for social and economic research (NISER). NISER findings show that about 73% respondents obtained their funds from personal savings while only about 2% obtained their funds from the financial institutions. (Terungwa, 2011). A more recent (2009) study indicate that there is improvement in funding of SMEs by the FFS. The percentage of financing of SMEs by FFS is now about 30% and the IFS is now about 70%.

Constraints To Smes Financing In Nigeria

The banks by their nature and position in the economy remain the known formal source of finance for enterprise. A 2001 World Bank survey on Nigeria showed that although 85% of the firms had relationship with banks, most of them had no access to their credit (Terungwa, 2011).

The lack of adequate financing for the SMEs is traceable to among other reasons the reluctance of banks to extend credits to them for the following reasons;

- Inadequate collateral by SMEs operators.
- Weak demand for the products of SMEs as a result of the dwindling purchasing power of Nigerians.
- Lack of patronage of locally produced goods.
- Poor management practices by SMEs operators.
- Undercapitalization.

Venture capital and equity is another source of financing for SMEs. Some of the challenges facing Nigerian policy makers in the area of venture capital include;

- Institutionalizing tax benefit for equity investment to attract foreign investors.
- Providing risk guarantees to create strategic venture capital industries that improve self-reliance and curb import quotas.
- Enhancing venture capital capacity to stimulate and promote the industrial expansion.
- Focusing equity investment on SMEs that optimize resource utilization and assist local raw material development.
- Promoting innovative business ideas, processes and techniques that boost both productivity and profitability.

Innovations/initiatives to overcome the financing constraints

The Federal government policy interventions for the funding of SMEs are generally geared towards improving the expected contribution of the sector to the growth and development of the national economy. Government has over the years introduced a variety of financing schemes and programs aimed at overcoming the financial constraints as witness by the SMEs in Nigeria.

Some of the initiatives to overcome the financing constraints of SMEs are:

- National economic reconstruction fund (NERFUND), established in the mid-1980s.
- Agricultural credit guarantee scheme fund (ACGSF), has between 1978 and first quarter of 2011 supported 701,000 beneficiaries with a total loan of N43.12 billion.
- SME II loan facility, the government secured a $270 million loan facility to further compliment other SME financing sources.
- The community banking scheme, established in 1991, with the objective of rural development, financial assistance to star-ups small and medium enterprises.
- Establishment of Peoples' bank and the family economic advancement program (FEAP) in 2002.
- The year 2002 saw Bank of industries (BOI) emerging from the merger of NERFUND and NIDB with the objective to provide credit at 10% to the industrial sector including SMEs.
- Refinancing and rediscounting facility (RF) in 2002.
- The microfinance initiative (MFI), introduced in 2005, with a policy to convert all the community banks to microfinance banks.
- The Small and Medium Enterprises Equity Investment Scheme (SMEEIS). As at the end of 2009, the scheme has attracted a total amount of N42.3 billion with N28.87 equity investment in 336 projects
- Intervention funds of N500 billion established in 2010 to improve access to credit by SMEs –N200 billion to refinance and restructure the outstanding credit portfolio of manufacturing SMEs in the country. As at June 2011, the sum of N197 billion had been disbursed to 539 SME projects. – N300 billion off-grid power and airline fund in support of SME clusters.
- N200 billion SME credit guarantee fund – here CBN provides 80% guarantee to deposit money banks (DMB) to encourage lending to SMEs. As at June, 2011, only N1.36 billion has so far been guaranteed.

The NEEDS (national economic and empowerment development strategy), SEEDS (state economic and empowerment development strategy) and LEEDS (local economic and empowerment development strategy) even though were employment generation and poverty alleviation schemes were all geared towards improving the income generating abilities of people and ultimately increasing their funding capabilities of SMEs. Despites the various machinery put in place by the government, SMEs continue to find it very difficult to access funds for its operations and which have invariably contributed to slow pace of development and growth of SMEs in Nigeria.

Kauffman (2004) has suggested a four pronged approach to increasing SME access to finance.

1. Improving business conditions which should lead to proper information, clear accounting standards, impartial legal system, effective bankruptcy procedures, favorable tax policies and prompt payment of government debts.
2. Helping SMEs meet the requirements of formal financing.
3. Making the financial system more accessible to SMEs.
4. Expanding the supply of finance through the non-financial private sector.

Despite the various initiatives and innovations in the area of financing SMEs, the problem of poor financing has remained as they have not been able to perform the role expected them. The contribution of SMEs to the GDP has remained well below 5%.

The Nigerian Stock Exchange (NSE) and the Security and Exchange Commission (SEC) have begun moves to encourage SMEs to list on the stock exchange and have access to capital from the capital market. Over 700 firms in Anambra state have been wooed to take advantage of the capital market. The NSE Onitsha branch has commenced discussions with some of the prospective SMEs to provide them the needed support to get listed on the exchange (cashcraft, 2012).

Conclusion And Recommendations

The SMEs in Nigeria account for over 90% of Nigerian business. Policy insight No.7 of the African economic outlook 2004/2005 states that Nigerian SMEs account for some 95% of formal manufacturing activity and 70% of industrial jobs. In spite of this dominance of the Nigerian economy by the SMEs, their contribution to the GDP is only about 1%. The SMEs in Nigeria are distributed in clusters in the regions with Anambra state having the highest number of SMEs in Nigeria. The very poor contribution of SMEs to the economic growth of Nigeria can be attributed to various reasons. However, access to finance by the SMEs is very critical to the success of the SMEs. Empirical evidence shows that finance contributes about 25% to the success of the SMEs. To alleviate the problem of funding, the Federal government and CBN have over the years established many credit institutions with the objectives of improving access to finance by the SMEs. These initiatives appear not to have paid off as the SMEs still contribute well below 5% to the GDP. In other economies in USA, Europe and UK, the contribution to the GDP is well over 40%. The Federal government and its agencies should in addition to setting up these credit institutions put in place policy targeted towards improving business conditions and the business environment.

The informal finance sector IFS provides more than 70% of the funds to the SMEs. What this means is that operators of the SMEs have easy access to funds from IFS. The Federal government should find out the factors that make this possible and incorporate such factors into its policy for improving SMEs access to finance. The Federal government and its agencies should also formulate policies that will encourage SMEs to source funds from the capital market.

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