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CAPITAL COST AND SUSTAINABILITY OF SMALL AND MEDIUM-SCALE ENTERPRISES (SMEs) IN NIGERIA

By:
Akan, David Chucks
david.akan@dou.edu.ng
Department of Accounting, Dennis Osadebay University, Asaba.
Sinebe, M.T.
michaelsinebe@gmail.com
Department of Accounting, Delta State University, Abraka
Bereprebofa, Dudutari
dudutari.bereprebofa@dou.edu.ng
Department of Marketing, Dennis Osadebay University, Asaba.

Corresponding: david.akan@dou.edu.ng

ABSTRACT

This study conceptually examines Small and Medium Enterprises (SMEs) funding issues, particularly in emerging nations using Nigeria as a case study. It analyses institutional barriers to funding small startup businesses, such as the high cost of capital, inadequate collateral and weak legal structures. It emphasizes the deficiencies they face regarding high maintenance costs, poor managerial experience, high competition from foreign firms, Government's inability in financing small and medium firms for them to attain their full capacity, weak Policies, changes in unstable tax tariff, and finally suggesting ways that can improve finance access for small and medium firms. The study recommends that individuals should acquire the necessary knowledge and skills pertaining to their chosen business endeavor through participation in entrepreneurial training programs, that government should promote the enhancement of SMEs capabilities through the localization of supply chains, encourage effective leadership at the highest organizational level and should be encouraged by the localization of value creation by actively engaging with SMEs. It also recommended that the government should increase the campaigns of elucidating the significance of taxation in fostering the growth of nations, while concurrently providing assistance to small and medium firms in comprehending the tax legislation in Nigeria.

KEYWORDS:

SMEs, Cost of Capital, firm profitability, start-up businesses, SMEs' financing

1. Introduction

Capital cost is often viewed as one of the initial investments required to start up or expand a business and it includes, among others, expenses such as purchasing or leasing equipment, buildings, and acquisition of inventory. Small and medium-sized businesses (SMEs) may experience a large impact from capital costs because; it affects many different facets of their operations. Capital cost can also refer to a company's long-term sources of funding, such as its debt financing and preferred equity, which are used to finance capital expenses on behalf of creditors and shareholders. Cost of Capital can be thought of as the cost of getting funds, which is also the cost associated with using capital. The cost of capital is another name for the expenses incurred in acquiring funds or capital as it is the rate charged for the utilization of capital fund for the business (Vélez-Pareja & Tham 2021). Khaled and Samer (2013) asserted that capital cost refers to the expenses incurred by a company or an individual to acquire or upgrade a physical asset, such as property, equipment or machinery for use in their business operations. However, since capital costs can include the purchase price of the asset, installation and setup costs, transportation and delivery fees, legal and administrative fees, and any other expenses directly related to acquiring the asset, these costs are typically incurred upfront and are considered to be a long-term investment that will generate benefits over the asset's useful life.

Capital costs are important for businesses as they affect the company's profitability, and overall cash flow. They are usually planned and budgeted for in advance and are considered to be important in the financial decision-making processes, such as calculating return on investment (ROI) or determining the pay-back period (Sinebe & Henry, 2023). In Chibuike (2023) opinion, SMEs are classified as businesses that employ less than 250 people and make less than N500 million in revenue annually. Micro, small, and medium-sized businesses (SMEs) in Nigeria are classified according to their personnel and asset base. Small businesses have between ten and forty-nine employees and assets between N5 million and N50 million, medium-sized businesses have between fifty (50) and two hundred and fifty (250) employees and assets between N50 million and N500 million, and micro-enterprises have less than ten (10) employees and assets under N5 million. Notably, over 84% of Nigeria's workforce is employed by SMEs, which account for 48% of the country's GDP, according to the National Bureau of Statistics (NBS). As a result, the goal of this paper is to conceptually examine how the application of cost of capital measures affects the growth of SMEs in Nigeria with the intention of adding to the body of knowledge by addressing the issues SMEs face through conceptual analysis, the review of conceptual research, and the provision of solutions to the issues raised.

2. Literature Review

2.1. Small And Medium-Scale Enterprises (SMEs)

SME is a term used to categorize businesses based on their size and operational characteristics, as they are, in general, characterized by their relatively small operating funds, limited resource availability, and typically smaller personnel counts than larger enterprises. The precise definition of a SME may vary across countries and industries. However, the idea of SMEs is crucial because these companies are essential to the economy as they are frequently seen as the foundation of many economies, particularly in developing nations where they account for a sizable amount of the commercial landscape (Bamidele, 2012; Gyimah, Akande, & Muzindutsi 2022). Governments and policymakers often focus on supporting and promoting SMEs through various initiatives such as providing access to finance, offering training and capacity-building programs, and creating a favorable regulatory environment.

SMEs face unique challenges and opportunities compared to larger corporations as they often have limited access to capital, face difficulties in attracting skilled talent, and have less bargaining power in the market (Addo, 2017). Conversely, they also have the advantage of being nimble, flexible, and able to adapt quickly to changing market conditions, therefore, the concept recognizes the importance of small and medium-sized businesses in driving economic development and highlights the need for targeted support of policies to enable their growth and success (Dawuda & Azeko, 2015; Sinebe, 2023). According to Chinaemerem et al (2012), SMEs often need to make investment decisions such as purchasing new equipment, expanding operations, or launching new products. The cost of capital helps SMEs determine the feasibility of their investment options by comparing the expected return on investment with the available cost of capital. This helps them make informed decisions and allocate resources effectively. Also, SMEs need to raise funds for their operations, and the cost of capital affects the availability and cost of financing options. When SMEs understand their cost of capital, they can choose the most appropriate financing options that align with their financial goals and minimize their overall cost of borrowing.

The cost of capital directly impacts the profitability of SMEs that if the cost of capital is high, it increases the cost of doing business and reduces profitability (Banji, 2010). By managing their cost of capital effectively, SMEs can improve their profitability and use the savings to fund other growth initiatives. Investors and potential buyers use the cost of capital mechanism to assess the risk and return of investing in or acquiring an SME. A lower cost of capital indicates a lower risk and can make an SME more attractive to investors or potential buyers; therefore, understanding the cost of capital helps SMEs identify and manage their financial risks (Adda, 2020). By assessing the cost of capital, SMEs can identify areas where they may be paying higher-than-average costs and take steps to mitigate those risks and expenses. This could involve renegotiating contracts costing, diversifying funding sources, or improving operational efficiency to reduce costs (Taiwo, Ayodeji & Yusuf 2012). This process implies that the cost of capital is essential for SMEs as it helps them make investment decisions, choose appropriate financing options, improve profitability, attract investors, and manage financial risks (Abimbola & Kolawole, 2017).

Businesses come in a variety of shapes, sizes, and levels of complexity, but they can all be identified by how they use their resources to achieve specific goals. Enterprises are typically divided into four categories: micro, small, medium, and big. Street sellers, small businesses, and other types of micro-business are typical. The micro-business is not anticipated to adhere to strict legal requirements and will mostly operate in the unorganized segment of the economy, which is linked to developing economies. Small and medium-sized enterprises (SMEs) make for a sizable portion of all activity in the formal sector of an economy, despite their slightly bigger size, relative formal structure requirements, and strong impact from business environmental factors (Amarteifio & Agbeblewu, 2017).

The nature of SMEs is all-encompassing in almost every sector of the Nigerian economy, and they are well established and well-documented to play a significant role in national development. These include increasing industrial base diversification and expansion, maximizing local resources and skills, increasing government revenue, creating wealth, reducing poverty, and reducing rural-urban migration, among others (Ogechukwu 2011; Sinebe 2023a). The majority of newly established SMEs fail to survive their first five years, and those that do either eventually shut down or perform below average levels, despite the efforts made by various governments and other stakeholders (OECD, 2018). In order to actualize the focus of SMEs as factors of economic growth in Nigeria, government at all levels has taken steps to improve the growth viability of the SME sub-sector (Ogbo, & Nwachukwu, 2012; Abbasi, Wang, & Abbasi, 2017).

2.2 Cost of Capital

The concept of the Cost of Capital for SMEs involves examining the fundamental concepts and considerations related to the cost of capital specific to these businesses. It refers to the expense or rate of return that a company incurs to fund its operations and finance its projects (Bereprebofa, Sinebe & Akpotu, 2023). For SMEs, understanding and managing the cost of capital are crucial as they often have limited financial resources and face unique challenges compared to larger corporations, their financial structure, which includes debt and equity financing, has an impact on this (Ayyagari, Demirgüç-Kunt, & Maksimovic, 2017).An organization is in distress when it is unable to generate enough revenue to cover its operational and contractual financial obligations, which can lead to bankruptcy, to this effect, the underlying causes of corporate organization distress are broken down into three distinct categories: internal causes, external causes, and macroeconomic causes (Sinebe, 2020). SMEs generally rely more on debt financing from banks, financial institutions, or even personal loans from owners. SME contributions to economies include employment generation, knowledge transfer, economic multipliers, innovation catalysts, and cluster expansion. Lemi, Megersa, and Bogale (2020) suggests that capital cost is the incorporation of all resources available and is dependent on elements specific to the company, industry, and nation, where all business- and industry-related features serve as the organization's macroenvironmental components. In order to retain the value of its equity and meet the expectations of its investors or shareholders, a firm must generate a minimum rate of return on its investments, which is also known as the cost of capital.

There are two main components of cost of capital which are Debt Cost and Equity cost; Debt Cost: This is the fee associated with borrowing money via debt products like bonds or loans. It is the amount of interest that the business must pay to its creditors. Debt cost is typically the debt's declared interest rate, making it relatively simpler to calculate, while Equity cost is the price incurred when fresh equity shares are issued in order to raise money. It is the return needed by the company's investors to make up for the risk they are incurring by purchasing the shares of the business. The more intricate process of figuring up equity cost entails forecasting the company's expected dividends, growth rate, and risk. The total cost of capital is determined by averaging the costs of debt and equity, with the weights based on the capital structure of the company (the ratio of debt to equity used to fund operations). The formula for the Weighted Average Cost of Capital (WACC) is;

WSCC=VExRe+VdXRdx (1-Tc)

Where;

E= Market value of the company's equity.

D= Market value of the company's debt.

V= Total value of the firm (E + D).

Re= Cost of equity

Rd= Cost of debt.

Tc= Corporate tax rate.

A criterion for assessing investment prospects is the WACC. Potential initiatives for businesses are deemed financially viable and may add value for shareholders if they produce a return greater than the WACC. On the other hand, if the projects provide returns that are less than the WACC, shareholder value may be reduced. Also, it should be noted that calculating the cost of capital entails making a number of assumptions and forecasts regarding future financial performance, market circumstances, and interest rates. Due to variations in risk and capital structure, it also differs between businesses and industries. As a result of this, the cost of capital influences organizations' capital budgeting, investment evaluation, and strategic planning, making it a crucial tool for financial decision-making

2.3 Theoretical Review

This study is based on the Working Capital Management Theory by Mcinnes (2000), which contends that, in order to retain the value of its equity and meet the expectations of its investors or shareholders, a firm must generate a minimum rate of return on its investments, which is known as the cost of capital. It stands for the lost opportunity cost of investing money in one investment as opposed to another with a comparable risk profile and that long-term (fixed) assets are used efficiently and economically to evaluate performance and the cash conversion cycle (aggregative method), businesses are expected to organize their finances, accounts payable, inventories, and accounts. This will enable them to meet their financial obligations. Working capital refers to the funds that a company requires to cover its operational expenses and maintain its current assets and liabilities. The primary goal of working capital management is to strike a balance between maintaining adequate liquidity for operational needs and minimizing the cost of holding excess working capital. Key principles and theories related to working capital management include; Net working capital, liquidity-Profits Trade off, Operating Cycle Theory, Conservative Approach vs. Aggressive approach, opportunity cost, Cash Conversion efficiency etc.

3.0 Empirical Review

In order to investigate the effect of the cost of capital on company performance in Nigeria, Peters and Imo (2023) examined samples from listed construction enterprises in Nigeria between the years of 2012 and 2021. The study's analysis of the cost of capital's effects on business performance used the Cost of Equity and The Cost of Debt as its proxies. Business performance was evaluated using return on assets. In agreement with the body of previous knowledge, the analysis also included the variable of earnings per share. The researchers carried a pool least squares regression using the core assumptions of OLS regression. The study's conclusions showed that cost of equity had an insignificantly favorable impact on firm performance during the study period, whereas return on assets of listed construction businesses had an insignificantly positive impact. The study's conclusions were that, for Nigeria's publicly traded construction businesses, the Cost of Equity insignificantly raises performance and the Cost of Debt insignificantly lowers it. Given that equity capital has a positive, significant impact on an organization's performance, corporate managers of Nigerian construction enterprises should deliberately try to get it, the study's findings suggest. However, it is not advisable for corporate entities to look for loan financing because it has a negative effect on the performance of enterprises, even when the effect is slight.

Sinebe (2023b) carried out a study with a population of 120 business owners from a variety of SMEs with the use of primary data to analyze the activities of Small and Medium Scale Enterprises (SMEs) and its impact on their financial management practices in their performance of SMEs in Asaba. The regression analysis showed that implementing Financial Management Practice could be advantageous and have an impact on the SMEs in the financial performance. It was concluded that small and medium-sized businesses would benefit from adopting sound financial management practices and when the owners have some kind of formal financial education.

According to Aremu and Muhammad (2022), market orientation, entrepreneurial orientation, and information technology all had an impact on how well small and medium-sized businesses (SMEs) performed in Nigeria. The factors affecting the performance of SMEs were explained using the resource-based value theory. Based on information collected from 130 surveys given to the CEOs, directors, and managers of SME organizations in Ogun State, Nigeria. Around 105 of the 210 questionnaires were returned and examined. It was discovered that two criteria, market orientation and entrepreneurial orientation, have a major impact on how well SMEs function, however there is no significant link between information technology and SME success. This study helped SMEs organizations design their future operational plans across a range of industries, including the education sector. The study's primary limitations were its small sample size and the absence of any external performance measures unrelated to procurement.

Eferakeya, Enakirerhi, and Erhijakpor (2022) looked at the effects of risk analysis methods and capital budgeting practices on SMEs in Nigeria. Their study found that risk analysis methods and capital budgeting procedures were rarely used by businesses. They also observed that the most popular risk analysis strategy appears to be the reducing payback method, with the payback period appearing to be the most widely utilized way. Their findings point to the importance of cash flow and short-term analysis for business investment recovery.

In Nigeria, Akanni, Bolanta, Wahab, Amin and Kamaluddeen (2021) looked into the difficulties in running small and medium-sized businesses successfully. Choosing 50 sampled SME in each of the three senatorial districts of Kwara State by using a population of all small and medium business enterprises in Nigeria. To determine the association between SME growth and problems, the three hypotheses were examined using the Ordinary Least Square (OLS) regression technique in Nigeria. The results showed a relationship between funds and the expansion of SME in Nigeria, a relationship between infrastructure and the expansion of SME in Nigeria, and a relationship between entrepreneur factors and the expansion of SME in Nigeria for the third of the tested objectives. Based on the findings, it was suggested that the government create an enabling environment for Nigerian SMEs in terms of infrastructure facilities, safeguard emerging industries, lower taxes for SMEs, and make money available through specialized loans with low or no interest rates.

With a focus on those in the Nyarugenge region, Twesige and Gasheja (2019) investigated how tax incentives effect the expansion of small and medium-sized enterprises (SMEs) in Rwanda. The sample was chosen using simple random and deliberate sampling methods. Descriptive statistics were used for the dataset analysis. A multivariate regression analysis was conducted to clarify the link between the various factors. The survey's findings showed that a sizable majority of participants—more precisely, 75.7%—expressed agreement with the assertion that they were educated about tax rules. The percentage of respondents who said they knew about the tax advantages provided to small and medium-sized firms (SMEs) was also much higher, at 78.7%. Additionally, the findings revealed that among Rwandan small and medium-sized firms (SMEs), value-added tax (VAT) rebates, wear and tear allowances, and loss carryovers had respective percentages of 100%, 94.1%, and 95.6%. According to the study's findings demonstrate the critical role that tax incentives play in encouraging small and medium-sized enterprises' (SMEs) long-term growth. The government must create laws that are especially adapted to handle problems with SMEs' (small and medium-sized enterprises) long-term expansion.

Success O. Abusomwan, Liberty and Arodoye (2017) looked into the short- and long-term effects of SME finance on the dynamics of Nigeria's Gross Fixed Capital Formation (GFCF). The findings and evidence that policies focused at promoting SME finance in Nigeria will always have a favorable impact on capital formation and, eventually, economic growth. They advised the government to keep implementing policies that will provide inexpensive funding to the SMEs sector, ensure that these monies are not diverted to other sectors, and create the institutional, legal, and infrastructure conditions necessary for SMEs to survive and expand. In spite of tightening monetary policy, they said that it will encourage increased investment and could be the key to bringing the economy out of the current slump.

Muneer, Ahmad, and Ali (2017) looked into the question of whether small and medium-sized enterprises (SMEs) contribute significantly to the expansion and improvement of the economy. Some SMEs are having trouble growing because of a lack of capital and managerial abilities. The purpose of this study was to investigate how agency costs affect small and medium-sized enterprises' profitability as well as the relationships between agency practices and financial management practices. The data analysis for this study focused on 200 SMEs from Faisalabad, Pakistan. Most of the study's data come from primary sources. For assessing the validity of the hypothesis, the structural equation model (SEM) with partial least squares (PLS) 3 is employed, and for descriptive analysis, SPSS 23. According to the study's findings, there is no relationship between agency cost as a moderator and the profitability of SMEs or financial management practices. The study strongly suggests that financial management practices should receive more attention.

Small and medium-sized businesses serve as accelerators for the economic development of nations like Nigeria, which require sustained economic growth, according to Gbandi and Amissah (2014). They emphasized that economies must pay close attention to the SME sector and take advantage of the significant potential it offers to produce employment, advance integration with large-scale sectors, better local technology, and output diversification. their investigation focused on how SMEs are financed in Nigeria and the various funding options available to them. It was determined though the SMEs must receive funding in Nigeria in order to play their part in the expansion and improvement of the country's economy.

4.0 Discussion

Understanding and managing capital costs are crucial for SMEs to make informed investment decisions and ensure the efficient allocation of resources. It is important to note that capital costs differ from operational costs, as the latter refers to the ongoing expenses incurred in the ‘day-to-day’ operations of a business, such as salaries, utilities, and maintenance. Some effects of Capital cost on the development of SMEs are outlined below as;

i. ***Limited access to capital:*** SMEs often faces challenges in obtaining sufficient capital due to their size and higher perceived risk. High capital costs can further limit their access to financing, making it difficult for the initial start-up or expand their businesses.
ii. ***Slower growth:*** Limited capital can hinder the growth potential of SMEs. Insufficient funds may restrict their ability to invest in new equipment, technology, or marketing efforts, which can slow down their business expansion and limit their competitiveness in the market.
iii. ***Higher operational costs:*** High capital costs can increase the operational expenses of SMEs. For example, if they need to borrow funds at high-interest rates, they will have higher debt servicing costs, which can impact on their profitability and cash flow.
iv. ***Limited innovation and competitiveness:*** SMEs often rely on innovation to differentiate themselves from larger competitors. However, limited capital can restrict their ability to invest in research and development, product improvement, or market expansion, making it challenging to stay competitive in the market.

v. ***Lower job creation:*** SMEs are significant contributors to job creation in many economies. However, high capital costs can limit their ability to hire additional employees or expand their workforce, leading to slower job growth and potential unemployment in the economy.

vi. ***Risks of failure:*** Insufficient capital can increase the risk of business failure for SMEs. Without adequate funds to cover initial expenses or sustain operations during difficult times, SMEs may struggle to survive, leading to business closures and job losses.

In order to mitigate the effects of high capital costs, SMEs can explore various options such as seeking for government grants or loans, crowd funding, angel investors or forming partnerships to share the costs. Additionally, improving financial management practices, reducing non-essential expenses, and focusing on profitability can help SMEs optimize their use of capital thereby enhancing their chances of success. Various writers have undertaken numerous studies on the effects of capital expenses on SMEs [Chinaemerem & Anthony (2012); Olatunji (2013); Ibrahim & Ibrahim (2015); Mohammed, Osemeke, & Ahmed, (2023)], yet the problems that SMEs confront still appear to be unresolved as they consistently face the same or new difficulties. As a result, the goal of this paper is to conceptually examine how the application of cost of capital measures affects the growth of SMEs in Nigeria with the intention of adding to the body of knowledge by addressing the issues SMEs face through conceptual analysis, the review of conceptual research, and the provision of solutions to the issues raised.

Small and medium-sized enterprises (SMEs) unquestionably contribute to economic, social, and poverty reduction in developing countries as they are a significant source of employment and generate sizable domestic and international, however, the lack of access to reasonably priced and effective sources of credit has been cited as the key barrier to SMEs' ability to contribute to economic advancement revenues [Etuk, Etuk, & Michael, (2014); Igwe, Amaugo, Ogundana, Egere. & Anigbo, (2018)]. Additionally, the competition that results from the emergence and extinction of smaller businesses as well as their entry and exit have a significant impact on productivity growth and, by extension, economic growth (OECD, 2017). Although Micro Finance Institutions (MFIs) have expanded rapidly in a number of countries, the extent of their credit remains constrained, making their support insufficient for many sized assignments.

5.0 Conclusion and Recommendations

Contrary to the general assumption, the study found out that misappropriation of capital cost is another major factor affecting the development of SMEs in Nigeria together with access to capital. However, it also suggests that having access to capital is crucial, but it cannot only support the growth of SMEs following the presence of other challenges like environmental considerations, operational bureaucracy, weak legislation, lack of or inadequate funding, multiple taxes, inefficient technology and weak supporting infrastructure, marketing problems, unfair competition, and a scarcity of raw materials; these frequently affect SMEs in Nigeria. SMEs in Nigeria have significant high rates of death. The situation is brought on by the lack of a defined mission and vision among the business owners. They frequently imitate what other prosperous companies have done without careful forethought.

Another mistake committed by SMEs is the placement of advertisements without matching items, which promote the staff rather than the company itself. Also, most SMEs find it difficult to distinguish between personal and corporate money, which is a troubling existential danger. The majority of SMEs in Nigeria, due to the ways they pool their funds together, struggle to distinguish between money for company investments and savings. The situation has caused some SMEs to go bankrupt while others are unable to reap the rewards of their investment.

Based on the foregoing discussions of this research, the following recommendations are proposed:
(1) The government has the capacity to effectively respond to the immediate requirement for start-up capital for small and medium-sized enterprises (SMEs) through the implementation of incentives aimed at facilitating SME funding and should be deliberately engaged in assisting SMEs growth.
(2) It is advisable for individuals to acquire the necessary knowledge and skills pertaining to their chosen business endeavor through participation in entrepreneurial training programs. This will enhance their preparedness and competence prior to engaging in such ventures.
(3) The implementation of tax holidays by the government is crucial as a significant tax incentive for recently founded small and medium firms (SMEs) due to its capacity to enhance their investment capabilities and provide exemption from other tax obligations.
(4) Effective leadership at the highest organizational level is required to increase the capacities of small and medium-sized firms (SMEs) through the localization of supply chains. The localization of value creation through active participation with small and medium-sized firms (SMEs) is one key accomplishment that large organizations may achieve. By doing this, these businesses can strengthen their license to operate by having a positive impact on the neighborhood. This can be done in a number of ways, including through encouraging collaborations between various market segments and exchanging business planning knowledge, among others.
(5) Small and medium enterprises (SMEs) ought to prioritize the use of tax advantages in order to enhance the efficiency and effectiveness of their operations.
(6) It is recommended that the government undertake campaigns aimed at elucidating the significance of taxation in fostering the growth of nations, while concurrently providing assistance to small and medium firms in comprehending the tax legislation in Nigeria. Implementing these steps will have a substantial effect in ensuring that tax incentives provided to small and medium enterprises (SMEs) exert a noteworthy influence on their overall growth.

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