

## **Obstacles for the Growth and Development of Small and Medium Enterprises in Sri Lanka: Case of North Western Province**

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### **ABSTRACT**

The backbone of the Sri Lankan economy is formed by Small and Medium Enterprises (SMEs) which is an essential component in a competitive and efficient market. New SMEs' role in the economy is vital as it addresses the issues of sustainable development; job creation, economic growth, competitive market pressure and the overall stimulation of the country's economy. SME failure rate in Sri Lanka is quite as high as 45%. Therefore, the primary objective of this study was to examine both internal and external organizational factors which are acting as obstacles for the growth of new SMEs in Sri Lanka. Thirty four major variables were identified as obstacles through Focus Group Discussions and literature review. Principal Component analysis (PCA) with Varimax Rotation was used to reduce the identified variables into five components. The most perceived obstacle was termed as Finance which is largely internal to the firm with an Eigen value of 8.17 and a percentage variance of 24%, while the other obstacles determined by PCA were Management (internal), Market (external), Infrastructure (external) and Economic (external) in descending order. The PCA has emphasized the stringency of providing collaterals/guarantees to obtain bank loans as the most impeding obstacle for the growth of new SMEs in Sri Lanka. Therefore, the study suggests that it is needed to revisit the micro finance accessibility of SMEs in the North Western Province (NWP) and to support them in formulating effective financial management plans within their early years from the inception to avoid failures.

**KEYWORDS:** Micro finance, New small and medium enterprises, Obstacles

### **Introduction**

Entrepreneurs are the change agents in economies. SMEs play a dynamic role in almost all economies throughout the world, especially in the evolving countries such as Sri Lanka while serving as stepping stones for large enterprises and most of the large enterprises have begun as SMEs at their inception. Small and medium enterprises have gained recognition as a major player of employment, income generation, poverty alleviation and regional development in Sri Lanka (Anon, 2002). Furthermore, they play a vital role in developing entrepreneurial skills and innovation, promoting economic growth and in wealth creation of the nation. The Government of Sri Lanka recognizes

SMEs as the backbone of the economy since they accounts for more than 75% of the total number of enterprises, providing 45% of the employment and contributing 52% to the GDP (Anon, 2015).

The term SME is used to denote micro, small and medium enterprises. Different countries use different definitions for SMEs based on their level of development. The commonly used yardsticks are total number of employees, annual turnover and total investment. In the Sri Lankan context, the SME policy framework defines SMEs (Table 1) based on the number of employees and annual turnover (Anon, 2015).

**Table 1. SME Definition in Sri Lanka**

Sector	Criteria	Medium	Small	Micro
Manufacturing Sector	Annual Turnover	Rs. Mn. 251-750	Rs. Mn. 16-250	Less than Rs. Mn. 15
	No. of Employees	51-300	11-50	Less than 10
	Annual Turnover	Rs. Mn. 251-750	Rs. Mn. 16-250	Less than Rs. Mn. 15
Service sector	No. of Employees	51-200	11-50	Less than 10

The Table 2 shows that the predominant sector is trade representing around 41% of the total establishments with 33% in service while the industry represents only 26%. Scale wise micro enterprises constitute 935,736 (91.8%) of the total while micro, small and medium added together represent 99.8% and the large sector is only 0.2%. (Anon, 2016).

**Table 2. Economic Sector Wise Distribution of Establishments**

Scale of the Establishment	Total No. Established	Industry %	Trade %	Service %
Total	1,019,681	25.6	41.0	33.4
Micro	935,736	25.3	42.0	32.7
Small	71,126	28.8	31.3	39.9
Medium	10,405	32.0	19.6	48.4
Large	2,414	31.6	36.9	31.5

*Source: Report on listing stage Economic Census 2013/14 page 27*

It is vital for Sri Lankan SMEs to look beyond Sri Lankan boundaries in order to gain sustainability and growth. The study is built on the start-up culture of SMEs. There are specific reasons which cause business failure among the SMEs. It explores the major question of why some businesses prosper while others fail under similar economic conditions. Most of the SMEs fail at their start-up stage itself. At present, the Sri Lankan government provides various services through a large number of public

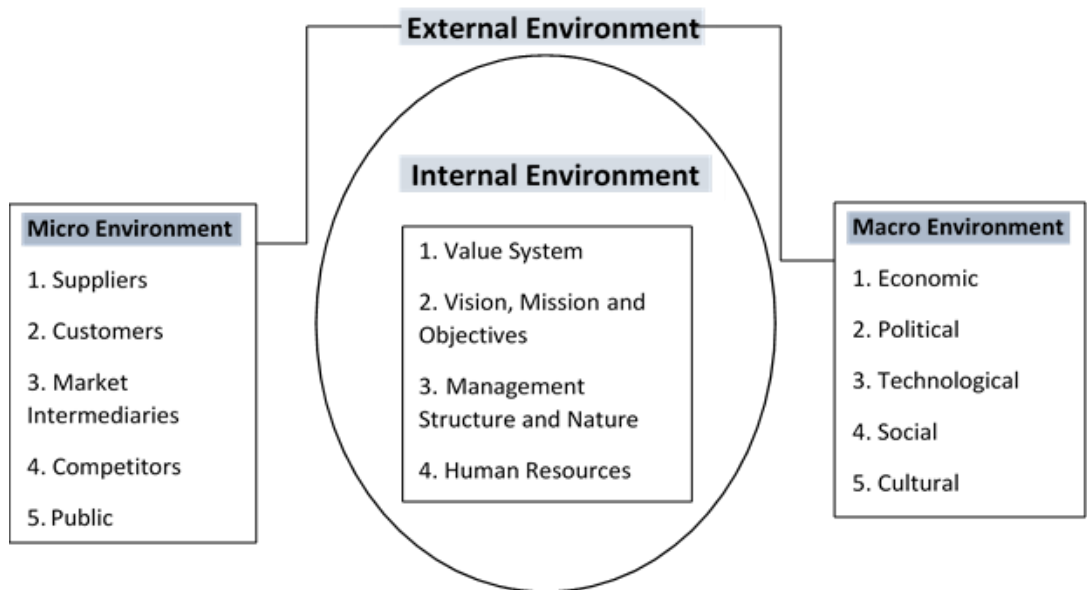
institutions which are directly involved in the development of SMEs in Sri Lanka. Even though, they provide various assistance such as providing loans, training, technology marketing, and management, the principal issue in the SME sector is its poor performance against the large scale enterprises in the national economy (Priyanath, 2014). Contribution of the SME sector is vital for the Government's efforts in the promotion of a balanced regional growth and development of the rural economy. The SME sector is a perfect platform for the government to build up human investment to a level where the latent benefits of a state-led SME drive could be fully realized (Weerakkody, 2015). For an example, in 1983, 98% of small enterprises accounted for 48.6% of the total employment and 31.1% of value added products. In 2008, 91.6% of small enterprises accounted for 29.6% of total employment and 20.3% of value added products (Priyanath, 2014).

It is observed that the statistics show a downward trend in SMEs in Sri Lanka. The Sri Lankan entrepreneur is culturally different from his/her western counterpart. Social power is a key motivator for the Sri Lankan entrepreneur. Studies have suggested that entrepreneurial motivation in Sri Lanka is entrenched not in the need for individual achievement, but in a conscious or unconscious need to satisfy a sense of social intimacy. Studies have also recognized business failure upon the exit, bankruptcy, or liquidation of the enterprise. The rate of business failure among SMEs in Sri Lanka is 45% (Bandara, 2016).

According to statistics published by the Small Business Administration, seven out of 10 new employer establishments survive at least two years and 51 per cent survive at least five years (Anon, 2011). Business start-ups often fail because founders and investors surge forward without taking time to realize that base assumption of their business plan is wrong. They believe that they predict the future accurately, rather than trying to create a future of their own. Entrepreneurs tend to be single-minded with their strategies wanting the venture to be all about the technology or all about the sales, without taking time to form a balanced plan. It is crucial to overcome these shortcomings.

The business environment is crucial for innovation and entrepreneurial development. It governs whether there are strong encouragements for individuals to identify market openings and generate wealth, jobs and economic growth. An aiding environment that makes it easy for individuals to startup businesses, run them, sell them and fold them if they are not successful is one that fosters national economic growth. It is clear that Sri Lanka needs to improve its business environment – the question for policy makers is, “where to start on this challenging agenda?” Sri Lanka's three most problematic factors for doing business are policy instability, access to finance and the inadequate supply of infrastructure according to the World Economic Forum's Global Competitiveness Report for 2006/7. This view is supported by the World Bank's earlier work on the investment climate in 2005 which highlighted electricity, policy uncertainty and access to finance as the key issues confronting formal sector businesses in Sri Lanka (“National Human Recourses and Employment Policy,” n.d.)

Business Environment can be defined as the combination of internal and external factors that influence a company's operative situation. Business Environment literally means all those aspects that have a bearing on the business such as its strengths, weaknesses, internal power relationships and orientations of the organization; government policies and regulations; nature of the economy and economic conditions; socio-cultural factors; demographic trends; natural factors; and, global trends and cross-border developments. Business environment plays a key role in shaping the business decisions and strategies of a firm. The opportunities and threats for a business come mainly from its external environment which includes factors like economic, political, technological and social. Similarly, the internal factors like managerial capabilities, efficiency in resource utilization etc. make and organization strong or weak (Figure 1).



**Figure 1. Components of Business Environment**

New SMEs are seen as a significant component of the solution to Sri Lanka's development issues, but most of the new SMEs fail during the first few years of operation. The objectives of this study are to identify major causes for such failures and to evaluate both internal and external environmental factors that stand as obstacles for the growth of new SMEs in Sri Lanka.

## **Methodology**

### **Data Collection**

Consequent to a comprehensive survey of literature and several Focus Group Discussions with SME owners, 34 obstacles were identified as major ones that impeded the growth of new SMEs. North Western Province was the study area which consisted of two districts, Kurunegala and Puttalam. Primary data were collected using a pre-tested structured questionnaire from a randomly selected sample of 170 newly

established SMEs in the area. Collection of data was carried out during the period from 01<sup>st</sup> March to 09<sup>th</sup> April 2016.

### **Principal Component Analysis**

Principal Component Analysis (PCA) is the general name for a technique which uses sophisticated underlying mathematical principles to transform a number of possibly correlated variables into a smaller number of variables. The origin of PCA lies in multivariate data analysis, the PCA has been called one of the most important results from applied linear algebra and perhaps its most common use is as the first step in trying to analyze large data sets. Some of the other common applications include; denoising signals, blind source separation, and data compression. In general terms, PCA uses a vector space transform to reduce the dimensionality of large data sets. The large number of internal and external variables make data analysis more difficult and complicated. The PCA is often used to overcome this obstacle by grouping together variables that are highly correlated into principal components. As a result, bring a simplification to analysis. The decision about which principal components to retain depends on the percentage of the variance accounted for by the variable, the absolute variance accounted for by each principal component and whether the component can be meaningfully interpreted (Olawale et al., 2010).

### **Data Analysis**

The use of five point Likert scale enabled respondents to indicate their opinion on a variety of factors of the business environment that have an impact on the start-up of new SMEs. A pilot study had been carried out to pre-test the viability of the questionnaire while its reliability was ensured by using Cronbach's Alpha. The large number of internal and external variables related to the obstacles for the start-up of new SMEs made the analysis of data more difficult and complicated. The PCA was used to avoid grouping of highly correlated variables together, instead of dividing them into principal components and, as a result it brought a simplification to the analysis. Bartlett's Test of Sphericity (BTS) and the Kaiser-Meyer-Olkin (KMO) were accommodated to measure the sampling adequacy and used to determine the factorability of the matrix as a whole. High values (between 0.5 and 1.0) indicate factor analysis is appropriate (Olawale et al., 2010). SPSS 23 statistical package was used for the analysis.

## **Results and Discussion**

The study comprises of two analysis methods as descriptive and inferential analysis. The PCA resulted five components which were named as Finance, Management, Market, Infrastructure and Economic based on the statements included in each component.

### **Descriptive Analysis**

The socio demographic characters of the sample revealed that majority of the SME owners were female (72.4%). Higher percent of female representation of SME owners

must be due to the type of business, milk based products and coir based products, which are dominated mainly by the female owners. The majority of the SME owners were between the range of 36-50 years of age (48.7%) (Table 1). This may be mainly due to the fact that younger generation prefers to employ in other occupations than being a SME owner. Further, it revealed that the most of the owners had completed both G.C.E. O/L and G.C.E. A/L examinations (40.1%) and the highest educational level observed was bachelors' degree (3.9%). However, young people with no proper educational background tend to join SME sector by their own dedication and commitment without staying unemployed.

It was observed that more than half of the owners (54.6%) had not registered their businesses with relevant government authorities. This may be due to reason that the fear of the SME owners to get involved with such authorities. Thirty eight percent of the SMEs were between one to three years in operation and nineteen percent of the SMEs were of less than one year. More than half of the owners had obtained loans (63.2%) while the majority had obtained loans from formal financial institutions (93.7%). Sixty eight percent of the loan obtained owners had provided government personnel as collaterals when obtaining loans from banks (Table 3).

**Table 3. Descriptive Statistics of the Sample**

<b>Parameter</b>	<b>Category</b>	<b>Percentage (%)</b>
Gender	Male	27.6
	Female	72.4
Age distributions	Less than 20	0.7
	21-35	30.3
	36-50	48.7
	More than 50	20.4
	Education level	Below Grade 10
Education level	Up to Ordinary Level	40.1
	Up to Advanced Level	40.1
	Graduates	3.9
	Diploma	2.0
	Business registration	Registered
Not registered		54.6
Time of establishment	Less than one year	19.1
	One to three years	38.2
	Four to six years	15.1
	More than six years	27.6
Loan obtained or not	Obtained	63.2
	Not obtained	36.8
Sources of loan	Bank	93.7
	Family	5.2
	Friends	1.1
Collaterals to obtain loans	Land	25.0
	Government Personnel	67.7
	Building	1.0
	Vehicle	6.3

### Inferential Analysis

To ensure the appropriateness to use PCA, the KMO and BTS tests were carried out. BTS 2.700E3 and the level of significance  $P < 0.000$  indicated that data were appropriate for the purpose of PCA. The results showed that KMO measure of sampling adequacy was 0.797 which indicated that there were sufficient items for each component (Table 4).

**Table 4. Kaiser-Meyer-Olkin and Bartlett's Test**

KMO Measure of Sampling Adequacy		0.797
Bartlett's Test of Sphericity	Approx. Chi-Square	2.700E3
	df	561
	Sig.	0.000

**Table 5. Variance Explained**

Component	Initial Eigenvalues		Extraction Sums of Squared Loadings		Rotation Sums of Squared Loadings	
	Total	Cumulative variance %	Total	Cumulative variance %	Total	Cumulative variance %
1	8.17	24.04	8.17	24.04	4.79	14.09
2	3.42	34.10	3.42	34.10	4.51	27.36
3	2.93	42.73	2.93	42.73	3.30	37.06
4	2.26	49.36	2.26	49.36	3.29	46.75
5	1.81	54.67	1.81	54.67	2.69	54.67

### Most Crucial Obstacles for New SMEs

#### Finance

The first component had an Eigen value of 8.17 and a percentage variance of 24.04% (Table 5). The component consisted seven statements. The statement with the highest factor loading was collateral/guarantee requirements to obtain bank loans which is said to be too stringent (0.838) (Table 6).

Usually bankers expect answers to five conditions when obtaining a loan, as; the amount of money requested, the way the money is being used for, the way the loan is collateralized, when the loan is going to be paid back and the way the loan is going to be paid back. If the owner fails to answer any of these questions properly, the red flag will be raised. Unwillingness of banks to lend money without collateral is the biggest problem.

This is because SME owner suddenly thinks to obtain a loan from a bank even without a bank account or a business plan. Therefore, the bankers do not have the trust that the loan will be paid back within the given period of time and they ask for trustworthy collateral. The other statements used to determine the extent of finance as an obstacle were, time consuming for processing loan application (0.833), lack of interest in obtaining loans from banks (0.792), too much restrictions from the money lenders (0.719), insufficient time for loan repayment (0.711), high interest rates for



loans (0.664), and difficulty of access to finance (0.503) (Table 6). The fact that the loan applications were time consuming since bankers take about three months for processing a loan. The lack of interest in obtaining loans from banks is due to various reasons such as fear of going to bank, inability to fill forms, reluctance to take risks and high interest rate. Component one was labeled as Finance.

**Table 6. Rotated Component Matrix**

Component	1	2	3	4	5
1. Collateral/guarantee requirements to obtain bank loans are too stringent	0.838				
2. The process of loan applications is time consuming	0.833				
3. Not interested in obtaining loans from banks	0.792				
4. Too much restrictions from the money lenders	0.719				
5. The repayment of the loan is not enough.	0.711				
6. Interest rates are high	0.664				
7. Access to Finance is difficult	0.503				
8. Poor knowledge about government rules and regulations		0.770			
9. Application of ICT is low		0.724			
10. Lack of awareness about quality certificates		0.661			
11. Lack of planning for the next stage of the business		0.642			
12. Lack of information about new technology		0.620			
13. Lack of knowledge in business planning/management		0.618			
14. Lack of higher education		0.603			
15. Cost for obtaining quality certificates are high		0.546			
16. Poor account management		0.496			
17. Difficulty in obtaining information on markets		0.402			
18. Difficulty in obtaining business registration		0.358			
19. Bad credit history		0.308			
20. Insufficient government support			0.704		
21. High production costs			0.680		
22. Infiltrations are high			0.657		
23. Decline of demand for the products			0.568		
24. Nonpayment risk on credit sales			0.566		
25. Lack of novel business opportunities based upon new technologies			0.523		
26. Interruption of water supply				0.813	
27. Poor roads				0.790	
28. Breakdown of electricity supply				0.782	
29. Poor communication facilities				0.770	
30. Location of the business is less pivotal now				0.482	
31. Inflation is high					0.684
32. High tax rates					0.652
33. Deterrent rules & regulations of the government					0.613
34. Political instability					0.499
Cronbach's Alpha	0.889	0.845	0.774	0.812	0.728

*Extraction Method: Principal component analysis. Rotation method: Varimax with Kaiser Normalization*

### Management

The component had an Eigen value of 3.42 and percentage variance of 10.06% (Table 5). The component consisted of 12 items. The item with the highest factor loading was poor knowledge about government rules and regulations (0.770). This may be because SME owners do not have much knowledge about government rules and regulations when registering and continuing their business. The other statements included were



poor application of information and communication technology (0.724), lack of awareness about quality certificates (0.661), lack of planning for the next stage of the next stage of the business (0.642), lack of information about new technology (0.620), lack of knowledge in business planning/management (0.618), lack of higher education (0.603), high cost for obtaining quality certificates (0.546), poor account management (0.496), difficulty in obtaining information on markets (0.402), difficulty in business registration (0.358) and bad credit history (0.308) (Table 6). The obstacle was labeled as management which is also internal to the firm.

### ***Market***

This component had an Eigen value of 2.93% and a percentage variance of 8.63 % (Table 5). This component was consisted of six statements. Insufficient government support to find the market (0.704), high production cost (0.680), high Infiltrations (0.657), decline of demand for the products (0.568), non-payment risk on credit sales (0.566), and lack of novel business opportunities based upon new technologies (0.523) (Table 6) were also included to measure the market component as an obstacle. This component is external to the firm and labeled as market which revealed that most of the SME owners are unable to find their target market. It was revealed that most of the SMEs have limited access to larger markets terms of market linkages, transport and information exchange.

### ***Infrastructure***

The component had an Eigen value of 2.26% and a percentage variance of 6.63% (Table 5). This component consisted of five items as; interruption of water supply (0.813), poor roads (0.790), breakdown of electricity supply (0.782), poor electricity supply (0.782), poor communication (0.770), and location of the business is less pivotal (0.482) (Table 6). This component is also external to the firm. Expanding and constantly upgrading of infrastructure facilities, and thereby bridging the disparity in facilities between the rural and urban areas may prevent failures at start-up stage

Further, location is critical to the success of a business at the start-up stage whereas a good location may enable a struggling business to survive and thrive ultimately while a bad location could spell disaster to even the best managed enterprise. Some factors to consider are customer base, traffic, and accessibility, location of competitors, the history, community flavor and receptiveness to a new product.

### ***Economic***

The final component with least importance consisted of 1.81 Eigen value and a 5.31% of variance with four items (Table 5). The component was labeled as economic which consists of high inflation (0.684), high tax rates (0.652), deterrent rules and regulations of the government (0.613) and political instability (0.499) (Table 6). The final component is largely external to the firm.

## **Conclusions**

The PCA discovered that the most crucial obstacle for business start-up of new SMEs in NWP is largely internal to the firm (Financial issues). Surprisingly, the second most critical obstacle, management, is also an internal factor to the business environment.

Small and Medium Enterprises are a vast developing sector and it is the backbone of Sri Lankan economy. Starting up a business in Sri Lanka is not a frightening task. A recent report gathered by the World Bank Group indicates an improvement in Sri Lanka's ranking as a potential destination to do , having risen to the 111<sup>th</sup> spot out of 190 countries in the 'Doing Business Index' for the year 2018. Accordingly, the start-up process in Sri Lanka now features only eight relevant steps, all of which take ten days (on average) to complete. The first eight steps are: (1) reserving a name; (2) appointing directors and a company secretary; (3) registering with the Registrar of Companies; (4) giving public notice of incorporation; (5) registering with the tax authorities; (6) registering for VAT; (7) payment of stamp duties; and (8) registering with the labor department (World Bank Group, 2018). Most of the respondents in the survey (55%) have not obtained their business registration under government authorities. This is mainly because they find that business registration is a costly, time consuming and unimportant activity.

SME owners do not have a specific plan for their business. However, they start the business and get stuck at the middle without being able to grow to the next stage of its life cycle. Hence, most of the enterprises get shut down and do not grow into large scale businesses. Many SMEs are of first time entrepreneurs, and they do not have sufficient bandwidth in all the functional areas. They are not able to estimate their own short-term and long-term needs accurately with all the uncertainties they encounter. Sri Lankan SMEs have not made great progress in the past.

They still struggle with tapping financial management. In most cases, SMEs are founded by entrepreneurs who are not managers themselves but they struggle to manage them due to the sole fact that they are the founders. Care must be taken often to study, organize, plan and control all activities of business operations. Most SMEs rely more on mental records and therefore, unable to prepare proper or up-to-date financial statements that can be used as evidence of profit and loss earned/occurred and wealth of the business including the working capital. This problem is even made worse where the entrepreneur, as the founder, manages their firm/company without necessary managerial skills.

Therefore, the study suggests that it is needed to provide up to date training programs to SME owners, government SME supporting agencies (such as National Enterprise Development Authority) should be vigorously marketed to create awareness among the public, introduce lower interest rate plans for loans, introduce new technology, improve infrastructure facilities and revisit the micro finance accessibility of SMEs and formulate effective financial management plans through closely monitoring and supporting SMEs in NWP within their early years from the inception to avoid failures.

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