Proceedings of FIKUSZ '14 Symposium for Young Researchers, 2014, 135-160 pp Published by Óbuda University http://kgk.uni-obuda.hu/fikusz

Impact of Firm Specific Characteristics in the Access to External Finances of SMEs

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Abstract: Small and medium-sized enterprises (SMEs) play a key role in the economic development of a country. This study investigates the importance of the small and medium-sized enterprises (SMEs) sector development. It analyses and determines the firm specific characteristics that affect SMEs' access to finance and especially external financing. The study compares the access to finance of EU SMEs with Albanian and Macedonian SMEs. This study uses the database of the surveys conducted by the European Central Bank and European Commission for 2011 and 2013 and selects the data for EU, Albania and Macedonia to test the hypotheses. Both Albania and Macedonia are developing countries and have the similar growth process of SMEs. The strongest point of Macedonia is the legal system, which helps the well-functioning of market economy. The Macedonian government completed the registration of real estates. This increased the access to external finance to Macedonian SMEs. On the other hand, the biggest problem of Albania is the registration of real estate. This factor puts a barrier in the access to external finance especially in bank loans for start-up or business growth (lack of collateral). The limitation of the study comes as a consequence of analysis based in the declarations that entrepreneurs of SMEs made by themselves and not in the statistical data of enterprises.

Keywords: Small to medium-sized enterprises, Company characteristics, External financing, Bank loan

1 Introduction

Small and medium sized enterprises (SMEs) are the dominant form of business organisation in developed, emerging and developing economies (Harvie & Narjoko & Oum, 2013, p.1).

SMEs are the true back-bone of the European economy, being primarily responsible for wealth and economic growth, because more than 99% of all European businesses are SMEs (nine out of ten SMEs are actually micro enterprises with less than 10 employees) and they provide two out of three of the private sector jobs and contribute to more than half of the total value-added created by businesses in the EU (European Commission, 2013, p.10)[1].

The advantages represented by SMEs such as the encouragement of entrepreneurship; the greater possibilities that SMEs will utilize labour intensive technologies and thus have an immediate impact on employment generation; the rapid establishment, operation and possibility to produce quick returns; the ability of SME development to encourage the process of both inter and intra regional decentralization; and the notion that they may become a countervailing force against the economic power of larger enterprises, confirm the importance of the role of SME's in the economic growth in transition countries (Gruda & Milo,2010, p. 5-6).

For transition economies (TEs) the SMEs have an important role because they are more flexible than large enterprises to respond rapidly the changes and they have the potential to generate jobs and income in this conditions (Hashi & Krasniqi, 2011).

The access to finance is the principal factor for SMEs business development cycle stages.

The MacMillian Committee in 1931 brought up the problem of SME finance (Mac Millan Committee, 1931). In this report this problem was firstly defined as the "finance gap". It refers to the situation in which an enterprise had grown to a size where it had made maximum use of short-term finance but was not yet big enough to approach the capital market for longer-term finance, particularly equity. According to this description the finance gap refers more to the impossibility of the SME sector to get long – term or equity financing. A firm with financing restrictions will have difficulties to invest in profitable projects and therefore will be less competitive.

The financial problems the SME sector faces can be a good explanation of the actual position this sector has in transition economies. The difficulties of obtaining access to finance can constrain the development in this sector. SMEs have to rely largely on their proprietor financial resources, which can be limited, as the level of economic development in these economies is low. Without access to outside sources of finance, these enterprises are condemned to remain very small and inefficient. In this way they can not contribute as they would do otherwise.

Several theories try to explain the financial behavior of firms in the attempt to find an answer to the question: Is there any target debt ratio that firms follow during their lives? The traditional theory, trade – off theory is based on the assumption that firms seek an optimal debt level (a target debt ratio) and that there is always a trade – off between the use of debt and the equity. This trade – off would be solved comparing the benefits of using the debt (tax shields) and the costs associated with the equity. The pecking order theory rather than implying a target debt ratio, states that the firms will follow a hierarchical path of financial resources beginning with internal resources, then

[1] http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/

preferring debt to equity when it comes to use the external resources. Myers & Majluf (1984) show that information asymmetry and the manager objectives are the premises for the existence of the Pecking Order Theory. Another theory that sheds light into the financial decisions of the firms is the life cycle stages of the firm. It implies that the firm will change its financial behaviour as it passes through different stages and as its financial needs change. Agency theory (Jensen & Meckling, 1976), try to explain the constraints of the firms in obtaining credit by banks which then would have an impact on the financial structure of the firms (especially small firms). The fact that the firm has information that the banks don't have will lead the bank in credit rationing (Stiglitz & Weiss, 1981) or will make the credit very costly for firms in terms of high interest rates or high collateral barriers. In this relationship the structure of the financial industry, the state of the formal and informal lending institutions and the macroeconomic environment, can also play an important role in increasing or decreasing the availability of funds for the business sector.

The preferences of the managers – owners of the firm will also define the financial decisions. Sometimes, especially in the SME case, they do not want to lose the control over the firm, or some times firm owners are "discouraged borrowers" that chooses not to apply to the bank because they feel that their application will be rejected (Storey & Kon, 2003).

The heterogeneity of SME sector makes to difficult the generalizion of results for all SMEs, and in especially related to financial behavior. Following we would analyze the above mentioned theories concentrating more on the pecking order theory and try to inter connect it with other theories.

2 Importance of SMEs Development

"The category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding 50 million euro, and/or an annual balance sheet total not exceeding 43 million euro (European Commission, 2014, p.1)."[2]
The definition of SMEs in Albania and Macedonia is closer to EU standards. However, the turnover criterion is far lower from the EU turnover level.

The SMEs have a greater importance for the Albanian and Macedonian business economy than in the EU, since about 81% of the population work in SMEs, having about 68% of the value added in 2011. The Albanian and Macedonian SMEs are distributed within the SME size-classes: compared to the EU, micro-firms have a greater share in the number of firms and they account for 45% of all employees of SMEs. Related to value added of large enterprises seen that their part is not much greater than that of small enterprises.
The importance of SMEs is increased with the privatization in the Former Yugoslav Republic of Macedonia (Bulevska, 2013). With the division of the Yugoslav market

[2] http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/sme-definition/index_en.htm

drastic change in the economic conditions lead to dissolution of medium-sized and large industries. In the 1990s, sole proprietorship business became popular.

Access to finance is improved, partly thanks to additional international credit facilities, primarily provided by the European Investment Bank (EIB) and the government continues to subsidise interest costs for SME loans, although on a declining scale in the 2012 budget (European Commission, 2013, p.25)[3].

According to SBA Fact Sheet 2013 – Albania SBA and Fact Sheet 2013 – Former Yugoslav Republic of Macedonia the overall performance of Albania and Macedonia about the general credit situation based in 4 indicators out of 10 is positive, and it is above the EU average.

In Albania, the most evaluated indicators are: willingness of banks to provide a loan and access to public financial support including guarantees; and less evaluated indicator is: the depth of credit information index. Also the well evaluated indicator is the strength of legal rights related to a higher degree of protection through the law bankruptcy and collateral, which is possibly linked to the scarcity of granted loans (European Commission, 2013)[4].

In Macedonia the access to finance is improved, partly thanks to additional international credit facilities, primarily provided by the European Investment Bank (EIB). Furthermore, the government continues to subsidise interest costs for SME loans, although on a declining scale in the 2012 budget (European Commission, 2013, p.25)[5]. From the available data, it is seen that the country has a good scoring in terms of depth of information on the credit system, despite being on a par with the EU average as regards the strength of legal rights is concerned. On the policy front, there were no implementations or announcement of new significant policy initiatives in 2012 and the first quarter of 2013.

There is a lack of public credit guarantee schemes in operation and other sources of finance, such as leasing and risk capital. There is a decline because domestic and external environment is not favorable. The legal and regulatory environment is progressing. The recent establishment of a fully functioning private bureau improved the credit information system. In Albania Banks reports a reduction in credit demand by businesses. There is a growth in the credit demand by households. According to bank's view, the main factors that lead to a reduction in credit demand by businesses are the current and expected macroeconomic situation and the decrease of the investors' need for financing.Credit standards applied to businesses, mainly to finance working capital and, to a lesser extent, to finance investments, are expected to ease (Bank of Albania, 2014, p.6)[6].

[3] http://ec.europa.eu/enlargement/pdf/key_documents/2012/package/mk_rapport_2012_en.pdf,

[4] http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performancereview/files/co-untries-sheets/2013/albania_en.pdf.

[5] European Commission Progress Report - Macedonia, 2012. Page 25, http://ec.europa.eu/Enlargement/pdf/key_documents/2012/package/mk_rapport_2012_en.pdf

[6] Bank of Albania. Monetary Policy Department. Bank Lending Survey Results for 2014 Q1 http://www.bankofalbania.org/web/Bank_Lending_Survey_Q1_2014_7062_2.php?kc=0,22,15,2,0

3 Literature Review

3.1 Pecking Order Theory and Firm Characteristics

3.1.1 Pecking Order Theory

Pecking Order Theory tries to explain the financial behavior of the firms. It gives us insides about the financial structure of the firms. Mayer (1984) and Myers and Majluf (1984) developed the idea of the Pecking Order theory as an explanation of the financial structure of the firms. In their work they assert that firms (managers) in the presence of information asymmetry (managers have information that investors do not have) would prefer to use internal resources first, then if it is necessary to get external resources they would prefer debt to equity. This is because the issuance of equities would be perceived as bad signal from the new investors resulting in a lower price for the new shares of the firm. Firms would use the equity only when they are constrained by the high leverage level. Myers and Shyam – Sunder (1999) and Goyal and Frank (2003) find evidence for the existence of the POT against the trade-off theory, others studies show that the trade-off is a better explanation for the corporate (Nuri & Archer, 2001). While there is a great debate about the relevance of the POT as a good explanation of the financial structure of corporate, there is a consensus that POT is a good explanation of the financial behavior of the SMEs. Forsaith and McMahon (2002) using a sample of Australian SME show that the equity is the last resort for the firms. Watson and Nilson (2002) also found evidence of the pecking order and shows that this POT exists not only in the traditional hierarchy, but there must be a POT within debt types as well. Hall *et al.* (2000) argue that the POT is 'more likely to arise in dealings with small enterprises because of their "close" nature, i.e. being controlled by one person or a few, related people, and their having fewer disclosure requirements. The cause of the POT would be the information asymmetry and agency problems arising between owner-managers and outside investors providing external finance. Zoppa and McMahon (2002) constructed a modified model of POT trying to capture the specificities of the SMEs. The model is as follows:

"• Reinvestment of profits (fully reflecting 'in-kind' contributions of existing owner-managers such as long working hours and below market salaries).

- *Short-term debt financing (beginning with major reliance upon trade credit and including use of personal credit card financing).*
- *Long-term debt financing (possibly beginning with longer-term loans from existing owners and owner-managers (that is, quasi-equity), and perhaps from their families and friends).*
- *New equity capital injections from existing owners and owner-managers (perhaps including their families and friends, and fully reflecting acceptance by existing owners and owner-managers of low or zero dividends).*
- *New equity capital from hitherto uninvolved parties (including new owners and owner-managers, venture capitalists, business angels and Second Board listing)* (Zoppa&McMahon, 2002, p.36*)."*

The factors that determine this hierarchy of choices are: Financing choices for SMEs are constrained to the retained earnings and bank loans as SMEs have limited access to capital markets. They face the finance gap which can be divided in "supply side gap"

and “demand side gap”. The *supply side gap* exist because of the presence of information asymmetry (small firms are informationally opaque) between banks and the firms, they have difficulties in obtaining debt. Stiglitz and Weiss (1981) and Nofsinger and Wang (2011) argue that this information asymmetry can lead to credit rationing, according to which, banks will not rise the interest rate to erase the excess demand for credit but will ration it. This can be a good explanation of the Pecking Order in terms of the use of retained earning or internal resources as the first option of financing. If banks do not ration they will raise the cost of borrowing in terms of high level of collateral and bureaucratic procedures.

Positive transaction costs also lead to supply side gap. Both the lender and the firm incur transaction costs in their relationship. The transaction cost for the lender consists in gathering information about the firm, analyzing and then monitoring the client. As transaction cost occurs independently of the size of the loan, it follows that the transaction cost (as a percentage of the loan) for the claims of the small firms would be greater than that of the large firm. Additionally, small firm, due to their special characteristics, do not disclose much information, which make difficult for the bank to find out the real overall situation and the rate of success of the firm’s investment projects.

The *demand side gap* means that for some reason the credit is not used because of the firms (owner-manager behavior). In term of transaction costs the firm also incurs transaction cost mainly in terms of time and resources needed to follow the practices for the credit application. According to the classical marginal theory (and implying rational behavior) the firms would ask for the credit if transaction costs are lower than the benefits of the loan. This would be more severe when owners think that they would be rejected. Kon and Storey (2003) investigate further in this issue and their theory of discouraged borrower show that good borrowers may not apply at all by the bank because they feel they would be rejected. In their work based also on previous research of Levenson and Willard (2000) they claim that the number of discouraged borrower is greater than the number of the borrower that apply by banks and are rejected, implying this way that the discouragement must be higher than the rationing, especially in less developed economies. The discouragement would incur under imperfect screening by the banks and the information asymmetry. The number of discouraged borrowers is shown to be a positive function of the level of application cost and availability of information. What is interesting is that the information asymmetry is supposed not only for the bank but for the firms as well. Young start-up firms are characterized by high informational asymmetries, in terms of the lack of prior business and bank relation experience. The collateral request raises more the number of discouraged borrowers. Despite the fact that firms know they have good prospects, the lack of tangible assets to use as collateral, discouraged them from applying by the banks, as they know that bank require collateral.

Another explanation for the demand side gap is the fact that owner-managers may be strongly averse to any dilution of their ownership interest and control (which are normally one and the same). Traditional or “life-style” SMEs follows a low growth path. Their owners generally have few or no growth aspirations. These businesses exist only to provide employment and returns to the owners. Knowing that a primary motive

for starting a small business may be to exert *greater* control over the working environment and to internalize the benefits of personal effort and risk-taking**,** this would appear logical.

3.1.2 Life Cycle Stage Theory

One of the theories that try to explain the financial behaviour of the SMEs is the life cycle theory, which states that the financial needs of the firm changes as the stages of development of the firm changes. As Berger and Udell (1998) imply, small firms are thought to have a financial growth cycle as the business grow. This means that different capital structures are appropriate in different stages of the cycle. In the start up phase firms are informationally opaque, have no credit experience, and have low level of tangible assets. In this phase they generally make use of internal funds as owner resources, or family and friends resources. As they grow, they may gain access to public debt and private equity.

But we must be cautious. The life cycle model may not apply to all SMEs. This is because sometimes, the owner managers of the firms follow up other objectives than the growth of the business. The data used in Berger & Udell (1998) show that the level of the resources the owner put in the business may raise when firms gets older. This can be explained from the fact that as firms grow they accumulate earnings, which in turns use in the business. Ferreira & Serrasqueiro (2000) confirm this. They show that SMEs may not diversify capital sources, even when they pass successfully the life cycle stages. This fact may also derive from the behaviour of the owner-managers who want to preserve their ownership as the firm get bigger and has better profit prospects. The same result is confirmed by Chittenden et. al (1996). In their calculations age is related negatively to total debt, reflecting the ability of older firms to accumulate their own resources.

Berger & Udell (1998, 2006) search, also show that the level of debt from financial institution (bank debt) is high for relatively young firms. This is explained with the fact that the owner-managers of these firms put they own wealth and their private assets as collateral to guarantee the loan repayment. They are also confined by the limited liability, which puts their personal wealth at stake to repay the loans independently from the presence of the collateral.

According to Chittenden et. al (1996), after survival firms need financial resources. This creates an over-reliance in the short term debt, which results from the lack of access in the long - term funds. Small firms would be facing the classical “finance gap”. Their study confirms this, as growth level combined with access to the stock market for long term finance result in lower liquidity.

According to Robb& Robinson (2014, p.177) in many cases the startup is a sole proprietorship or somehow involves personal assets as collateral for the loans in question, this implies that many entrepreneurs hold highly levered equity claims in their startups.

3.1.3 Agency theory

According to Cull at al. (2006) traditionally SMEs tend to be formed with owner’s equity which is obtained through personal connections, but after that they may tend to

rely on internal earnings for growth. But this does not erase the need of the SME for external funds in order to adapt to the new business and economic environment (outsider growing opportunities). They also may want to make use of new technologies. When we speak for outsider finance there are mainly two possibilities external finance (mainly bank debt) or external equity. Information opacity would result as a significant obstacle to the free flow of capital in general. In particular, Berger & Udell (1998, 2006) suggest that access to debt and equity by small firms will be influenced by three aspects of informational opacity: high verification costs, adverse selection, and moral hazard.

Classical financial theory predicts that capital markets should ensure that funds flow to investment opportunities with positive net present value. According to this theory in the capital markets the interest rates would serve as a regulator for the quantity demanded and offered. According to Petersen & Rajan (1994) the practical reality is often quite different. One of the key explanations is that information asymmetries and agency costs impede the free flow of capital (Stiglitz&Weiss, 1981). Since information asymmetries are likely to be greatest in the case of small privately-held firms, they may be the most who suffered from these market imperfections. All this can result in credit rationing or higher cost of capital for small and medium firms.

Much of the external debt of the SME is constituted from the bank debt. In this way the bank can be seen as the main provider of the external finance for the SME sector. But due to the problem of information asymmetry the SME sector faces a lot of difficulties in accessing the credit market.

The ***principal agent model*** is used by several authors to explain the environment and the attitudes of the bank and the firm in the presence of these market imperfections. Lean & Tucker (2001); Binks & Ennew (1996); Chittenden et al. (1996) explain that the availability of credit for SME is constrained due to the information problems. Under information asymmetries investors may be unwilling to provide funds for the entrepreneur because of agency problems. As we mentioned above in these conditions moral hazard and adverse selection will condition the decision of the credit providers. The moral hazard lies in the fact that the firm owner may undertake risky projects through the debt finance, given that he will fully benefit from the return (if the investment is successful) or he will share the cost of the failing project if the project does not result successful. On the other hand the adverse selection problem may occur on the part of the bank, because it acts to the moral hazard problem by increasing the *price of the loan. This may cause good borrowers to withdraw their loan request.* Instead bad borrower for the reason explained above will accept even very costly loans. The situation of high verification loans is connected to the fact that the lender, especially for the SME sector finds it difficult and costly to collect the information and monitor the performance of these enterprises. The problems of adverse selection and moral hazard are given by Altman (1968) in the work of Lean &Tucker (2001). The presence of information asymmetry may result in bad investments being accepted by the bank or also good prospects being rejected. This gives us these errors which are categorized as type I and type II error.

Therefore, the problem of the firm and the bank is to reduce these errors. The bank must increase its ability in screening and monitoring especially for the type one error, which

is of great importance to the bank. On the other hand the type two errors is the one which can hamper most the SME sector. Because of information asymmetries good financing projects in the SME sector can be rejected because the bank has not enough information to assess the performance of the firm. It is a problem that comes from the firm itself as it must find ways to signal its financial position. Therefore, we must say that if for the type I error only the bank may suffer and it is mainly its responsibility to improve its lending operation, the type II error includes the efforts of both the bank and the firm in order to avoid it. To avoid "bad borrowers" and to accept "good borrowers" the bank must improve its screening devices (Stiglitz & Weiss, 1981).

Credit rationing is one of the theories that shed light on the problem that information asymmetry creates. As we mentioned above the banks may react to the agency problem by credit rationing or by increasing the interest rates and collateral requirements (Stiglitz & Weiss, 1981). The credit rationing theory explained by Stiglitz & Weiss (1981) explain us that there must be an optimal interest rate (i*) for which the bank has the maximum expected return. As the bank wants to maximize its profits (expected returns), it can not let the interest rate play its role as the regulator of the credit market. So if the interest rate (i*) that maximizes the expected return to the bank is lower that the equilibrium interest rate then a shortage must exist in the credit market. This shortage is known as credit rationing. Stiglitz & Weiss (1981), discuss the role of the interest rate as a screening device. Apart the traditional effect it has on the increase of bank returns (higher interest rates, other thing equal, higher the bank returns), it can also reduce the expected return value for the bank. The second effect is caused by two effects that the interest rate can have on the behaviour of the borrowers. Firstly, increasing the interest rate may discourage the good borrower from the credit market as their projects may become infeasible. Secondly, increasing the interest rates may increase the incentives of the existing borrowers to engage in riskier projects which lower return for the bank (Stiglitz & Weiss, 1981). Under these assumptions it is argued that the bank may not use the interest rate alone as a screening device. Under the credit ration theory, the bank prefers to ration credit rather than to raise the interest rate. In the condition of the credit rationing there is an excess demand for funds at the market interest rate. This may imply that the SME sector may be underfinanced by the banks.
Instead of rationing bank would use different tools in order to solve the problems of information asymmetry and to reduce the excess in demand for funds. Different authors state that the bank uses the collateral as a screening device in providing finance, especially to small firms. Collateralization reduces adverse selection and moral hazard. It induces a borrower to reveal his or her default risk acting as a signaling device (Besanko & Thakor, 1987). Besanko & Thakor (1987) show us theoretically that the bank may distinguish low risk from high risk projects by the combined use of collateral with the interest rate. According to them good borrowers would choose low interest rates – high collateral options, as they know that their projects have high probability of success. On the other hand bad borrowers choose lending contracts with high interest rates and low collateral requirements. According to this there must be a negative relationship between the level of interest rate and collateral requirements.

But, Stiglitz & Weiss (1981) show that collateral may induce an adverse selection problem that associates higher levels of collateral with higher average borrower risk. Berger & Udell (1998) analyse two type of collateral inside and outside collateral. They

refer to the personal guarantee of the firm owner as the outside collateral, and the assets owned by the firm. According to them, more risky or informationally opaque small firms would pledge collateral more often. The availability of collateral or the owners' personal guarantees can make more desirable the use of external debt as compared to the internal finance, permitting the firm to maintain its full ownership and control.

According to Robb & Robinson (2014) the bank is providing liquidity for the startup, while the entrepreneur is bearing the risk associated with default through the liens on their personal assets.This number seems high given the commonly held view that the informational opaqueness of startups makes them poor candidates for lending.The top three sources of financing for most startups are, in order of average prevalence, bank debt, personal equity, and trade credit (Robb & Robinson, 2014, p.177)

3.2 Characteristics of Company and Financing Constraints

3.2.1 Industry effect

Industry is used as an explanatory variable to show that the financing decision can be a function of the type of the industry where the firms operate. Theoretically industries where the level of intangible assets is low like service industry we can expect low level of debt and more owner funds. Alternatively the level of debt must be high as the financing needs may be high, or because these firms may have collateralizable assets which can reduce their information problems. This can seen more in large firms but the connection is valuable for small firms as well. Harris and Raviv (1991) conclude that the industry effect is more important if we compare between industries. Its effect lowers when we compare firms in the same industry; leaving place form firms specific effects.

3.2.2 Size

The size is seen as an important factor that determines the financing decision of firms. We would expect for larger firms to be more leveraged (use more debt). The reasons for this can be explained in terms of information asymmetry. Larger firms mean more tangible assets which can be used to reduce the adverse selection. Different authors confirm these relations. According to Gibson (2002) smaller firms are associated more with principal equity firms, and large firms are combined with debt and equity cluster. Hutchinson, et.al (1998) found a negative relationship between total debt and size. This relationship is stronger for short term debt and micro enterprises. In their later work (2003) they also confirm a negative relationship of size to short term debt and find a positive relationship of size to long term debt. Goyax & Edwards (2004) find that size is negatively related to equity as large firms tend to be more diversified in terms of financing resources. Frank & Goyal (2004) find that leverage is positively related to size, which is consistent with the other studies mentioned above.

3.2.3 Asset Structure

Hutchinson (2003) finds a positive, significant relationship of asset structure with long term debt and a negative, significant relationship of asset structure with short term debt. This difference in the relation can be explained with the fact that the presence of tangible assets may opens for the firm the possibilities to apply for long term debt

instead of short term (increasing in this way the liquidity). In regard to the debt equity choice, Chittenden et al. (1996) find that firms with higher asset structure (more tangible assets) are associated with predominantly debt cluster. This is in concordance with the pecking order hypostudy, in that firms prefer debt to equity when they have this possibility. Frank & Goyal (2004) show that leverage is positively related to collateral, which means that firms with high level of tangible assets tend to use debt more than firms with lower levels. This result is also confirmed by Zoppa & MacMahon (2002). On the other hand Edwards & Gygax (2004) find a negative relationship between the asset structure and the level of equity.

3.2.4 Age

The implication that the age of the firm has on its financial structure can be seen more on the light of the life-cycle stage theory. Buck et. al (1991) using US data on SME show that business age is positively related to the probability of loan approval. This means that young businesses have a higher likelihood of being denied a loan request. Petersen & Rajan (1994) also arrive at the same conclusion. Hall et.al (2004) find that age is negatively related to the short and long – term debt, but only for the UK SMEs and this relation is vice verse for the Spanish SMEs. So we would expect that older firms will use less debt as compared to younger firms.

3.2.5 Profit Structure

Myers & Majluf (1984) and later Zoppa & McMahon (2002) connect profitability to debt policy. According to them the higher is the level of profitability, the lower is the need of the firm for external sources of finance. We can insert here the POT framework according to which the firm would prefer to use internal sources before outside debt or equity. These imply that SME which have lower levels of profits would be more demanding in the credit market. They can be also more constrained form this fact as they do not have healthy financial position. Hall and Hutchinson (1998) find a negative relationship between profitability and long-term debt which means that firms who do not have internal funds to rely on, would seek external finance. In a later work Hall et. al (2004) using a sample of European SMEs find also a negative relationship between the level of short and long term debt with the profit level. Frank & Goyal (2004) find a negative relationship between the dividend paying firms and the leverage. This may be inconsistent with the pecking order theory, as dividend paying firms would have less internal funds available to use for financing needs. But we can also interpret it another way. Firms that pay dividends may be in better financial position. This means that they have sufficient funds to use as retained earning as well as to pay as dividends. Another interpretation given from them is that these firms may be seen as financially healthy and this would simplify their way to external equity. In this case equity would be less costly that outside debt. Returning to the SME, at least in their initial development phase the owners does not take any part of profit, as they sacrifice themselves in order to develop the business. The dividend issue in the small business sector is whether it would be paid at all in the time of growth, which according to Ang (1991) it is a small business unique. In this way it is more the profit level that can be connected to the financial needs of the small firm.

3.2.6 Growth level

A priory, or invoking the POT framework high growth firms with large financing needs will end up with high debt ratios (because of the reluctance of the owner to outside equity). According to a study of the Australian manufacturing SME Forsaith & McMahon (2002) firms can be divided in some layers according to their behavior towards growth. They identify three categories: life-style firms which do not have aspiration for growth, capped growth SMEs which have modest growth aspiration and entrepreneurial SMEs which have ambitious growth aspiration. We would expect to have a positive relationship for growth and debt ratio for the last group, as their main concern is the growth of the business whatever the way to reach it is. Smith & Whatts (1992) find that high growth firms use less debt in their capital structure. According to Hall et.al (2004) growth would push the firm toward borrowing. According to them growth would be negatively related to long term debt and positively related to short term debt. This is because firm would try to avoid the higher cost of long term debt by using short term debt. This would permit to the firm to take fully the benefits of growth opportunities.

Regarding the growth factor there is a confusion in prior results where some studies support an association between growth and the debt level (Cassar & Holmes, 2001) while others do not (Jordan et al. 1998).

3.2.7 Firm location

Firm location is another firm specific factor that can have an influence on the financial structure of the firm. Since for getting external finance the firm must apply by the banks for obtaining assets, the location of the firm would have an important impact on the information asymmetries that would exist between the bank and the firm. Generally firms located in periphery or in rural regions would be more informationally opaque as compared to their urban counterparts. For the bank it is more difficult to obtain information about the performance of these firms. Also the firm itself would have less information on where to find the debt, on the use of debt and the procedures and requirements to qualify for it. Also the transaction costs in terms of time and efforts made for applying for the debt would be much higher for these firms. We would expect that firms operating in rural areas or peripheral areas use less debt and operate more using their internal resources. If compared with the past Petersen & Rajan (2000) show that distance is a barrier. But it will be a barrier if the banking industry is concentrated or if it is not dispersed through all the country in the same way.

4 Methodology

This study aims to investigate on issues of SME financing in Europe and especially in Albania and Macedonia emphasizing external sources of finance.

Research questions

1. What are the key sources of external finance for SMEs?
2. What are the key factors (firm characteristics) that contribute at external financing (especially bank loan)?

Hypothesis of study

SME access to external finance is related to firm characteristics:

Size, Industry effect, Asset structure, Firm Age.Profit structure,Growth level

The research starts by a critical review of the contemporary literature and the studies of Albanian and Macedonian authors. This review served to create a theoretical basis for our empirical research. The above mentioned models of Zoppa and McMahon (2002); Klapper et. al (2002) was used to analyse the Pecking Order Theory in order to test for demand driven low level of credit in SMEs. The determinants of credit access (financial constraints) of SMEs were analysed using the works of Solano & Canovas, 2003; Berger and Udell, 1995; Petersen & Rajan, 1994; Elsas et.al, 1998; Klapper et. al, 2002. The statistical data of Bank of Albania, INSTAT, Eurostat and the database of the survey 2013 of SMEs' Access to Finance conducted by European Commision will used to investigate the relationship between the access to finance the SME sector and company characteristics in Albania and Macedonia compared to EU countries.

Data used in the analysis was accessed from the Survey on the Access to Finance of Small and Medium-sized Enterprises (SAFE) conducted by the EC (European Commision) and the European Central Bank (ECB) which collaborate since 2008 on this survey.

The survey provides information on *SMEs'*[7]*:*

- *Financial situation, growth (past and future), innovative activities and need for external financing*
- *Use of internal funds and external sources of finance*
- *Experiences when they apply for external financing*
- *Use of loans, the size and reasons behind taking out specific loans*
- *Views about the extent to which different types of financing are available to them*

The sample in each country was stratified by size of enterprises and an additional stratification by sector (industry, construction, trade, services). A CATI (Computer Assisted Telephone Interviewing) methodology was used. The individuals with responsibility for the company's financial decisions, such as Managing Director/Owner/Proprietor, Chief Executive Officer and Chief Financial Officer/Head of Finance were interviewed.

For the purpose of this study (which focuses on to access to credit of SMEs), we have also excluded from the SAFE database the large firms (with more than 250 employees) and we selected only the data for EU total, Albania and Macedonia (as neighboring countries). The following table represents the selected sample for this study.

[7] http://ec.europa.eu/enterprise/policies/finance/files/2013-safe-analytical-report_en.pdf

Year of survey	Countries	Total	Micro enterprises 1-9 employees	Small enterprises 10-49 employees	Medium 50-249 employees
2011	EU-27	13,859	4,427	4,491	3,762
2013	EU-28	12,666	4,368	4,498	3,800
2011	Albania	102	35	33	34
2013	Albania	90	30	32	28
2011	Macedonia	100	34	33	33
2013	Macedonia	90	30	30	20

Table 1.

Distribution of sample according to selected countries[8]

5 Results

The database of the results by business characteristics and the results by countries of the surveys conducted by the European Central Bank and European Commission for 2011 and 2013 and selected the data for total EU, Albania and Macedonia help us to do the :

Comparisons of results between SMEs in EU, Albania and Macedonia related to:

- *Usage of internal funds and external sources of finance*
- *Experiences when applying for different types of external financing.*
- *Use of loans and reasons behind taking out specific loans*
- *The most important limiting factor to get the financing*

When seeing the sources of financing that have been used in the last six months, 54% only external financing was used by EU SMEs compared to 2011 levels (56%). Around 21% had a use of both internal and external sources of financing, and 4% had a use of only internal sources. We conclude that the levels are unchanged from 2011.

38.2% of Albanian SMEs had used only external financing compared with 20.1% in 2011. Macedonia has a same percentage 61.6% in two years and close to the European average.

[8]Author's proccesing based at http://ec.europa.eu/enterprise/policies/finance/files/2013-safe-analytical-report_en.pdf and http://ec.europa.eu/enterprise/policies/finance/files/2011-safe--analytical-report_en.pdf

		2011	2013	2011	2013	2011	2013
The loan of your firm (during last 2 years)		**Total-EU 27**	**EU 28**	**Al**	**Al**	**FYROM**	**FYROM**
No loan taken	%	47	47	47	50	29.4	33.7
Loan taken	%	50	50	**15**	**15**	**70.6**	**66.1**
The provider of the last loan							
Bank	%	86.8	85	**100**	83	80.5	**84.4**
Relatives or friends	%	4.2	5.4	-	5	14	1.0
Other	%	8.8	9.3			5.6	10.9
DK/NA	%	0.2	0.6	-	12		
The reason to get a loan							
Working capital	%	45.6	43.3	40.2	45.5	57.1	53.3
Land/ buildings/ machinery and equipment	%	43.6	44.3	45	26.5	22	**40.6**
Research and development or intellectual property	%	4.6	3.7	-	-	1	6.9
Promotion	%	3.1	1.8	-	18.3	12	-
Staff training	%	2.6	1.5	-	-	-	6.9
Buying another business	%	4	3.7	10.9	4.8	0.3	0.8
Other	%	13	12.2	-	4.9	8.3	6.6
No answer	%	0.1	-	-		-	

Table 2.

Obtaining of loans and the reasons

Source: Database of Access to finance 2011 and 2013[9] Author' own calculations

Macedonia has the highest percentage of responses that take a loan and the primary source of this loan is the bank with an increase of 3% in 2013.

In the above table, SMEs in EU liked more to get a loan (over 50%) but for Albania was not frequent (15% was unchanged in 2011 and 2013) but more preferable in Macedonia (71%- 2011 and 67% -2013)

The pricipal provider of loans for SMEs in the EU was banks. 85% of SMEs who got a loan used the bank compared with 5% from friends or relatives and 9% used other resources.

Albania has a reduction of 100% in 2011 to 83% in 2013 in lending from banks, while Macedonia has a raise in the percentage of debt by banks from 80% to 84%, a reduction from 14 % to 1% for Private individual - relatives or friend and rising by 5 to 11% for other sources (eg Microfinance Institutions, government-related sources).

The two principal reasons for EU SMEs to provide a loan were for land/buildings/equipment or vehicles (44%) or for working capital (43%). Only 4% of

[9] http://ec.europa.eu/enterprise/policies/finance/data

SMEs had taken loans for research and development/intellectual property or to buy other businesses (4%).
There was seen a raise in the demand in loan for working capital in Albania (up from 40% in 2011 to 45% in 2013) and a reduction for land/buildings/equipment (from 27% to 22% in 2013)
There is low reduction in requesting loans for working capital in Macedonia (down from 57% to 53% 2013), but raise most for land/buildings/equipment (from 22% to 41%).

		2011	2013	2011	2013	2011	2013
The most important limiting factor to get the financing		Total-EU 27	EU 28	Al	Al	FYROM	FYROM
No barriers	%	35.4	36.4	8.6	29.9	35.5	30.8
Not enough collateral or guarantee	%	**21.7**	**19.6**	**5.4**	**23.3**	**18.9**	**19.1**
HighInterest rates or price	%	19.5	18.8	13	20.7	14.8	32.6
Decreased control over the firm	%	2.7	2.7	-	-	1.3	-
No availability of financing	%	6.1	7.7	12.7	4.0	23.6	10.3
Other	%	9.9	9.2	-	1.5	4.2	7.2
DK/NA	%	4.8		60.3		1.7	

Table 3.

The most important limiting factor to get the financing

Source: Database of Access to finance 2011 and 2013[10] Author' own calculations

The above figure helps to understand the fluctuations at answer *"Not an efficient collateral or guarantee"* of the question "*The most important limiting factor to take the financing?"* at our selected countries.

Albania in global level stands at 119 and Macedonia stands at 84 in the ranking of 189 economies on the ease of registering property (*World Bank. (2011).Doing Business* database). Also this ranking helps an entrepreneur with information about the easing to transfer property in Albania and Macedonia.

The first source that SMEs use when they want to start a new firm is internal finance (loans from friends or relatives and personal savings). Secondly they use external finance from financial institutions. The pecking order theory is supported by the results.

SMEs that have higher profit margins and adequate internal funds do not use external fu nding which is consistent with the pecking order hypostudy.

Finally, SMEs with bussiness expansion plans have the demand for external finance.

SMEs that have a high profit margin tend to lend less. The SMEs that are mature have e asier access to longer term finance. When a SME wishes to have longer term finance it i s helpful to possess collateral.

[10] http://ec.europa.eu/enterprise/policies/finance/data

5.1 Company characteristics and external financing

The database of the results by business characteristics of the surveys conducted by the European Central Bank and European Commission for 2011 and 2013 not contained the results by countries and was obligatory to use only the data for total EU.

The data helped us to test the hypostudy.

5.1.1 Industry effect

If we compare between industries we conclude that services companies were less likely to used external financing (52.9%) than other sectors, because the level of tangible assets is low and they use more internal funds.
The most secure sector in requesting and taking loans and is the industry sector, with 69% security of the outcome, compared to 63% for trade, services (63%) and construction (61%).
Also the menagers of industry were ready to aim for over €1 million in external financing. 17% of them said that this was their goal, compared to 11% of construction firms, 10% of firms in services, and 9% of firms in trade.

Source of financing	Industry	Construction	Trade	Services
Internal funds usage	3.1%	3.1%	3.3%	4.1%
External financing usage	54.6%	57.6%	55.7%	**52.9%**
Internal funds and external financing usage	28.1%	22.5%	21.7%	**20.8%**
No source of financing used	14.2%	16.9%	19.3%	22.1%

Table 4.
Source of financing and sector
Source: Database of Access to finance 2011 and 2013[11] Author' own calculations

5.1.2 Size

An important role is also played by company size. Small firms have less debt. This explained from the information asymmetry problem due to which smallest firms encounter problems in finding external finance. Therefore they are forced to find other forms of finance that debt.

The following results confirm that micro enterprises were less likely to use debt financing (67%) and medium enterprises were more likely to use the debt financing (86%). The results support the hypostudy that exist a positive relationship between company size and the using of the debt financing.

[11] http://ec.europa.eu/enterprise/policies/finance/data

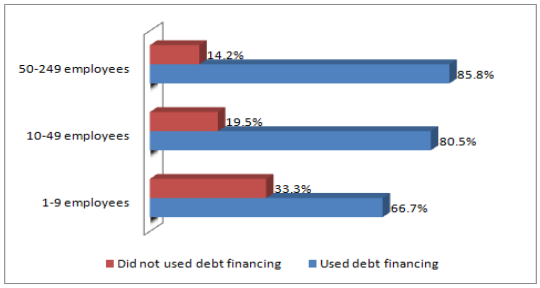

Figure 1.

Company size and financing debt

Source: Database of Access to finance 2011 and 2013[12] Author' own calculations

5.1.3 Asset structure

The degree to which assets are tangible and generic would increase the possibilities a firm has to obtain external finance. In the context of information asymmetry, tangible assets can be used as collateral, and this would lead to a reduction in adverse selection and moral hazard problem.

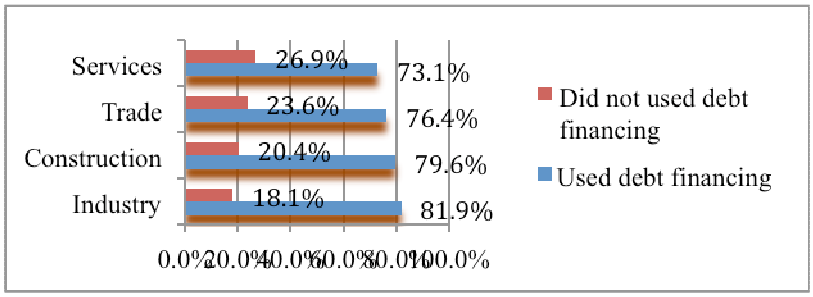

Figure 2.

Debt financing and asset structure

Source: Database of Access to finance 2011 and 2013[13] Author' own calculations

These results (figure 5) confirm the conclusions of Frank & Goyal (2004); Zoppa & MacMahon (2002) that firms with high level of tangible assets (industry-81.9%) tend to use debt more than firms with lower levels (services-73.1%).

5.1.4 Age

Younger firms which are in their initial phase of development tend to have less internal resources in terms of retained profit. This means that we would expect younger firms to have a higher demand for credit. But we cannot say the same for the use of credit. As

[12] http://ec.europa.eu/enterprise/policies/finance/data

[13] http://ec.europa.eu/enterprise/policies/finance/data

younger firms have less collateralizable assets they may have more difficulties of getting finance. Also as they lack experience in dealing with credit problems or they have no financial records which can show their financial status.

On the other hand older firms can have more assets which can pledge as collateral but they may also accumulate more retained profits, which can be used as financial resources. Following these characteristics of older firms the implication can be diverse. If we discuss in terms of the probability of a loan approval, older firms are expected to have a higher probability of loan approval for the reason above mentioned. But older firms also are expected to have higher level ef retained profits. They have more consolidated financial results. This may imply that they have more retained earnings to use as internal financial resources.The table tell us that 33.4% of new firms (less than 2 years) had no source of financing used, having the greatest level of rejection of their application to bank loan (27.8%) compared to 9.7% of rejection for oldest firms (10 years or more).

The sourcing of financing	Less than 2 years	2 years - less than 5 years	5 years - less than 10 years	10 years or more
Internal funds usage	4.0%	2.6%	3.3%	3.7%
External financing usage	50.3%	54.4%	56.4%	53.6%
Internal funds and internal financing usage	12.3%	16.2%	20.0%	23.6%
No source of financing used	**33.4%**	26.8%	20.2%	19.1%
Bank loan (new or renewal excluding overdraft and credit lines)				
Applied and all taken	53.8%	48.0%	56.1%	68.2%
Applied and between 75% and 99% taken	2.2%	6.7%	7.7%	9.4%
Applied but between 1% and 74% taken	10.8%	8.4%	8.3%	6.9%
Applied but rejected (high cost)	4.0%	3.1%	1.7%	1.7%
Applied but rejected	**27.8%**	24.0%	19.7%	9.7%
DK/NA	1.4%	9.8%	6.6%	4.1%

Table 5.

Source of financing, bank loan and company age

Source: Database of Access to finance 2011 and 2013[14] Author' own calculations

5.1.5 Profit structure

For the firm in general it can be said that firms with higher levels of profit will need less external finance. This comes from the fact that the internal resource (profit) is used to finance the operations and the financing needs. We can insert here the POT framework according to which the firm would prefer to use internal financing before external financing or equity. These imply that SME which have lower levels of profits would be

[14] http://ec.europa.eu/enterprise/policies/finance/data

more demanding in the credit market. They can be also more constrained form this fact as they do not have healthy financial position.

Based in results of survey we conclude the profit level of firms is negatively related to the using of external financing.

	Up to euro 2 million	More than euro 2 million and up to euro 10 million	euro 10 million and up to euro 50 million	More than euro 50 million
Internal funds usage	4.7%	2.6%	2.4%	4.2%
External financing usage	55.8%	56.8%	53.1%	**41.1%**
Both internal funds and internal financing usage	16.8%	28.0%	35.0%	43.3%
No source of financing used	22.8%	12.6%	9.5%	11.4%

Table 6.

Profit structure and source of financing

Source: Database of Access to finance 2011 and 2013[15] Author' own calculations

5.1.6 Growth level

According to responses of survey the innovative companies[16] shows higher levels of growth. High-growth companies[17] and "gazelle[18]" have particular problems about the additional funding for their growth.

There was an important change between SMEs in terms of level of growth. The most pressing problem for gazelles was the access to finance (23%) while for SMEs with a high-growth was 18% and they with medium growth was 12%.

Small and young firms (gazelles) often lack the financial capacity or have difficulties to get funding or financial capital for reasonable conditions, because the banks are reluctant, and they perceive a greater risk, and thus, tend to charge large risk-premiums (Mitusch & Schimke, 2011, p. 28)

Growth levels of SMEs (high, moderate or none) or whether the business was a "gazelle" made little difference to application levels for bank loan[19].

[15] http://ec.europa.eu/enterprise/policies/finance/data

[16] According to European Commision "*Innovative' SMEs are defined as having introduced innovation in at least one area, such as products, services, marketing, production or management*"

[17] SMEs which are experiencing growth of more than 20% per year over a period of three years

[18] The term "gazelle" is used for high-growth companies that are young, which is defined as all those that are up to five years old

[19] http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/supporting-documents/2013/annual-report-smes-2013_en.pdf

Our conclusion supports the result of Jordan et al. (1998) that there is not a association between growth level and the debt level.

6 Conclusions and Recommendations

The determinants of SMEs development are: macroeconomic and microeconomic environment; skills of entrepreneurship (training, education, etc); economic and social condition for enterprises; financial assistance; non- financial assistance (supporting with counseling, services, research, etc).

Both Albania and Macedonia are developing countries and have the similar growth process of SMEs.

Although Macedonia is a developing country, it has similar evidence with EU. The strongest point of Macedonia is the legal system, which helps the well-functioning of market economy. The Macedonian government completed the registration of real estates. This increased the access to external finance to Macedonian SMEs.

On the other hand, the biggest problem of Albania is the registration of real estate. This factor puts a barrier in the access to external finance especially in bank loans for start-up or business growth (lack of collateral).
SMEs use internal finance as the main source of finance for start-up. For the growth of the business the primary source of finance is the external finance. This supports the pecking order theory.
Insufficient access to appropriate finance needs to be seen as a serious obstacle to the development of SMEs. The microenterprises as smaller firms have a greater risk for bankruptcy and because they can assure smaller amounts of securities than their larger counterparts. Banks hesitate to give loans to small firms and when they do the interest rates are higher.

The results indicate that, there are significant differences in the use of external financing between micro, small and medium firms. The use of external financing is less in small firms in comparison with medium firms. Our analysis shows that firm size is important to determine the use of external financing. The use external financing is less in small firms because of information asymmetry problems.

There are differences in the use of external financing between sectors (industry, construction, trade, services). External financing is used more in construction industry and less in services. This is related with the asset structure of the firms. The firms having more tangible assets have more access in external financing.

Age of the firm has a key importance in the use of debt financing. The younger firms have the higher demand for loans and also higher rejection from banks due to lack of collateral. On the other hand older firms have lower demand for loans due to higher internal financing. The percentage of older firms (10 or more years) that apply and take the loan is 20 % greater than younger firms (2-5 years).

Based in the results of the survey we conclude that more profitable firms have little need for external financing.
According to Beck et al (2013, p.30) the dominance of banks in most financial systems across the developing world is indeed associated with the limited access to financial services by enterprises.

The results of this study state that special financing schemes should be introduced in order to help small firms easily access external financing.

Further research can consist on a survey conducted with entrepreneurs of SMEs. The questionnaire will be designed according to the necessities of the theoretical analysis. The sample would be chosen in order to capture the regional differences, the location differences (rural and urban areas), the sector differences as well as the size differences. This survey will be designed in order to account for special characteristics as cultural effects (on entrepreneur behavior), the level of remittances (in Albania's and Macedonia's case), etc.

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