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The Impact of Ethics on the Availability of Trade Credit to New Small and Medium Sized Enterprises (SMEs) in South Africa

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ABSTRACT The failure rate of new SMEs in South Africa is one of the highest in the world. Non-availability of external finance is one of the primary causes of failure. This study investigates whether the ethical challenges faced by new SMEs are a constraint on the availability of trade credit, a major source of external debt finance. Data was collected through self-administered questionnaires in a survey. Data analysis included descriptive statistics, Chi square goodness of fit test, T-test and ANOVA. The results indicate that ethical challenges faced by new SMEs impact on the availability of trade credit. Recommendations to improve ethical behaviour of new SMEs are suggested.

INTRODUCTION

According to the World Bank (2008), the three major development challenges facing South Africa are high levels of poverty, income inequality and unemployment. The government of South Africa agrees that solving these three development challenges is a primary objective. Pahad (2008) points out that South Africa's social-economic goals are clear; reduce inequalities, reduce wealth and asset gaps between rich and poor and halve unemployment by 2014. One of the ways of meeting the challenges is ensuring the development of the small and medium enterprises (SME) sector. SMEs are a key to poverty alleviation, income equality, employment and sustainable economic growth (Parliament of the Republic of South Africa 2005). FinMark Trust (2006) assert that unemployment remains a huge problem in South Africa today. One of the best ways to address unemployment is to leverage the employment creation potential of SMEs and to promote SME development, (refer to Table 1 for the quantitative definition of SMEs in South Africa).

Table 1: Definition of small and medium enterprises in South Africa

Type of firm	*Employees*	*Turnover*	*Balance sheet*
Small	1-49	Maximum R13m	Maximum R5m
Medium	51-200	Maximum R51m	Maximum R19m

Government Gazette of the Republic of South Africa, 2003

However, if the contribution of SMEs is to be sustained, new SMEs will have to be created. New SMEs form the new basis from which an economy can expand and stimulate accelerated socio-economic growth and development and job creation. An increase in the number of new SMEs will lead to an increase in economic growth. The renewal capacity through the creation of new firms is crucial in today's knowledge based economy (Reynolds et al. 2003; Maas and Herrington 2006; Puhakka 2007). Hong and Daly (2005) point out that the contribution of new SMEs to economic development includes: New SMEs: trigger competition; stir research and development and innovation; push old firm to improve their efficiency; inject new blood into the veins of the economy; result in economic growth, technological upgrading, job creation and welfare improvement. Mutezo (2005) supports the argument that new SMEs make a significant difference to economic prosperity and that South Africa risks economic stagnation without a high new SME creation rate. Social problems such as crime and corruption are likely to increase. In South Africa, a new SME is one that has existed for less than forty two months. After that period, the SME is considered an established firm (Maas and Herrington 2006).

South Africa has one of the lowest creation rates of new SMEs in the world. In 2008, South Africa ranked 23rd out of 43 countries, with a Total Early-Stage Entrepreneurial Activity (TEA) of 7.8% which was below the average rate (10.6%) of all the countries surveyed by the Global Entrepreneurship Monitor (GEM). In addition, South Africa has the highest failure rate of new SMEs in all the countries sampled by GEM. 75% of new SMEs fail within the first two years of creation. The probability of a new SME surviving beyond 42 months is less likely in South Africa than in any other GEM sampled country (Maas and Herrington 2006).

Lack of sufficient capital and credit is often a major handicap to the development of SMEs, particularly in their early growth stages. Better access to finance is identified as key strategic element in promoting entrepreneurship and enhancing competitiveness and capacity at the enterprise level (Rogerson 2008). According to Demirguc-Kunt et al. (2006), the two primary sources of external finance for new SMEs are equity and debt. External equity in the form of venture capital or the stock exchange is usually not available for new SMEs. The lack of venture capital funds makes many new SMEs dependent on bank loans and overdrafts and trade credit for early-stage financing. Despite the dependence of SMEs on debt finance, paradoxically access to debt finance is very limited for new SMEs, especially in developing countries. Commercial banks and trade creditors hesitate to lend to new SMEs. Stiglitz and Weiss (1981) refer to this phenomenon as capital rationing.

FinMark Trust (2006) provides evidence that only 2% of new SMEs in South Africa are able to access bank loans and that the use of trade credit by new SMEs is virtually non-existent. (Less than 1%). According to Smorfitt (2009), new SMEs in South Africa do struggle to raise debt finance. The question is Why? Previous studies on improving access to debt finance by SMEs in South Africa such as Hawkins (2002), Angela Motsa and Associates (2004), FinMark Trust (2006) have focused mainly on improving the availability of bank credit whilst completely ignoring trade credit. Wilson and Summers (2002) reveal that banks are not the only principal source of external debt finance for SMEs. Berger and Udell (2006) note that trade credit provides a cushion during credit crunches, monetary policy contractions or other shocks that leave financial institutions less willing or less able to provide small business finance. Since only a limited number of new SMEs have access to loans from financial institutions, trade credit may often be the best or only available source of external funding for working capital. New SMEs may prefer trade credit financing during the early years when the risk of default is high.

Furthermore, most of the extant literature on how to improve access to finance has concentrated on factors such as managerial competencies (Cizel et al. 2007; Martin and Staines 2008), collateral (Barbosa and Moraes 2004; Berger and Udell 2006), Business information (Pretorius and Shaw 2004; Kitindi et al. 2007), networking, (Ngoc et al. 2009). Howorth and Moro (2006) posit that the decision to grant credit is often based on the evaluation of from financial statements and/or the provision of collateral, and/or credit scoring. These three lending technologies are all grounded on hard facts and public information available. However, soft information such as ethics and trust is also important in the lending process. Ethical perception of the borrower plays an important role in reducing agency problems such as moral hazard and adverse selection. This implies that there are different sources of information that lead to the decision to lend. Lepoutre and Heene (2006) found that small firms experience more difficulties than their larger counterparts when engaging in ethically responsible behaviour. Hannafey (2003) points out that new SMEs face significant resource pressure. Thus, liability of newness may lead new SMEs towards more individualist ethical postures.

According to Omolewu (2008), Painter-Morland and Dobie (2009) and Lather (2009) the most important ethical relationships in terms of business sustainability are with customers and suppliers. These relationships have to do with trust and predictability. SMEs in South Africa face many ethical challenges that seriously compromise their sustainability. New SMEs are primarily concerned with surviving that ethics will be compromised if there is any business advantage to be had. Ethical challenges faced by new SMEs include not meeting commitment to suppliers, perception of dishonesty and lack of business experience, skills and competencies. Howorth and Moro (2006) argue that lack of skills and competencies negatively impacts on the ability of new SMEs to perform. Ability is an important factor in trustworthiness and ethics. These ethical challenges may affect the willingness of trade creditors to grant credit to new SMEs and thus constrain the availability of trade credit to new SMEs.

The rest of the study is organized as follows: Section two will review the theoretical and empirical literature on ethics. Section three will focus on the research methodology. Section four will discuss the results and conclusions. Section five will focus on recommendations and provide the managerial implications of the research findings while section six will examine the limitations of the study and suggest areas for further research.

Literature Review

Ethical Theory and Firm Performance

Smit et al. (2007) and Hellriegel et al. (2008) describe ethics as the code of moral principles and values that direct the behaviour of an individual or a group in terms of what is right or wrong. Ethics is a set of values and rules that define right and wrong behaviour. Ethics affects both individuals and business organisations. At business level, ethics relates to the principles of conduct within organizations that guide decision making and behaviour. Business ethics are the standards used to judge the rightness or wrongness of a business' relations to others. Business ethics can be defined as the methods, principles and processes a business or organization brings to bear on compliance to legislation; compliance to regulatory and professional standards; compliance to company standards; keeping promises and commitments; and abiding by general principles or values, for example, fairness, truth, honesty and respect.

The stakeholder theory by Freeman (1984) is a theory of organizational management and business ethics that addresses morals and values in managing an organization. Stakeholder theory begins with the assumption that values are necessarily and explicitly a part of doing business. The theory stipulates that managers need to articulate the shared sense of the value they create, and bring its core stakeholders together. Stakeholders include shareholders, employees, suppliers (goods and funds) customers, and the communities in which the firm operates. According to Freemam et al. (2004), the appeal of stakeholder theory lies in its capacity to provide robust answers to the question as to why should a firm be managed ethically and what does this mean for the way business is coordinated. Stakeholder theory creates a mechanism and thereby opens the door to bringing fundamental moral principles to bear on corporate activities. The stakeholder theory begins with the assumption that values are necessarily and explicitly a part of doing business, and rejects the separation thesis. The separation thesis argues that ethics and economics can be neatly and sharply separated.

The stakeholder theory takes into consideration all the stakeholders of a business and is divergent from the shareholder theory espoused by Friedman (1970). The argument of the shareholder theory is that managers ought to serve the interests of the firm's owners, the shareholders. The social responsibility of the business is to increase its profits and obey the laws of the society and not necessarily to be ethical. Business ethics therefore overlaps with the philosophy of business. If a company's main purpose is to maximize the returns to its shareholders, then it could be seen as unethical for a company to consider the interests and rights of anyone else. Empirical studies on the impact of ethics on firm performance tend to agree with the stakeholder theory rather than the shareholder theory. Kotter and Hesket (1972) set up the theoretical foundation for a host of empirical studies on the impact of ethics on firm performance. Kotter and Hesket found that firms perform better when their cultures emphasize the interests of all stakeholders (customers, employees, stockholders, suppliers, providers of funds). Donker et al. (2008) found that ethics has an impact on employee commitment to work and lead to improvement in the financial performance of a firm. In addition, the stock markets react negatively to firms that commit socially irresponsible or illegal acts. These findings are consistent with the results of other empirical studies on ethics and firm performance such as Kaler (2000) and Erondu et al. (2004).

Ethics and New SMEs

In South Africa, King Reports 1994, 2002 and 2009 stressed the importance of business ethics as part of good corporate governance for both large firms and SMEs. The King Reports went beyond the financial and regulatory aspects of corporate governance in advocating an integrated approach to good governance in the interests of a wide range of stakeholders having regard to the fundamental principles of good financial, social, ethical and environmental practices. The King Report 2002 listed seven characteristics of good corporate governance. These are corporate discipline, transparency, independence, responsibility, accountability, fairness, social responsibility.

Omolewu (2008) posits that in a dynamic business environment, a large gray area exists that makes it difficult and unclear to distinguish what is ethical. An unethical behavior would therefore be defined as one that is not morally honorable or one that is prohibited by the law. Unethical behaviour by firms include corruption, mail and wire fraud, discrimination and harassment, insider trading, conflicts of interest, improper use of company assets, bribery and kickbacks, compliance procedures, ethical relations with others, disciplinary action, fraud, illegal business donations, false accounting and information, patent infringement and product liability.

Lather (2009) observes that due to the increasing pressure to conform to ethical practices, large companies have started addressing the concept of business ethics more seriously than before. It is the SMEs that need to be closely monitored because not only do they lack resources but also they lack the leadership to adopt ethical practices. Their mismanagement affects the ability of SME companies to incorporate responsible and ethical practices in their business operations. SMEs are often individually-owned or family-owned enterprises managed by family members, which creates challenges for reporting unethical conduct and managing conflicts of interest. SMEs rely far more on informal processes such as verbal communication than on the formal policies and procedures that structure large enterprises. They thus lack the sound organizational systems that support ethics programs in large organizations.

According to Spence and Rutherfoord (2003), the major thrust of ethics research has been large organisations. There is little information on SMEs. The researchers argue for a reorientation away from the large multinational firm as the benchmark study of business ethics research. While it is true that business ethics as a discipline emerged at a time when the large firm was seen as the main focus of business study, today, SMEs remains the dominant form of business organization in both developed and developing countries. Failure to address small firm ethics is totally inappropriate and a fundamental flaw in current business ethics research.

Howorth and Moro (2006) point out that ethics and trust play an important role in reducing agency problems such as moral hazard and adverse selection. The decision to lend by providers of funds is often based on the evaluation of from financial statements and/or the provision of collateral, and/or credit scoring. These three lending technologies are all grounded on hard facts and public information available. Private information is often soft data, which, by definition, is difficult to summarise in numeric score, and is influenced by the context in which it is collected. This indicates the central role of soft information in the lending process since the essence of successful lending is overcoming asymmetric information problems between the borrower and the lender that would otherwise create incentives for borrowers to default their loans. This implies that there are different sources of information that lead to the decision to lend. Where ethics is low, the general perception of riskiness is greater. In addition, contracts will be more stringent with tight terms and conditions. This includes tight monitoring and collateral.

Spence and Lozano (2000) indicate that there are certain differences between a large firm and an SME. Unlike large firms, SMEs are likely to be owner-managed. This provides greater scope for individual beliefs and moral decision making to affect the practice of the business as a whole. In addition, social relationships and networks in which these owner managers are entwined cannot be separated from the business. Therefore, researchers examining business ethics may not generalize their findings to SMEs. Grayson (2005) explores the question of whether ethics differs in the settings of large firms and SMEs and provides the answer as “Yes” and “No”. No because the same principles apply. These are minimizing your negative social impacts and maximizing your positive impacts. Yes because there are differences between the two types of business organizations. SMEs are primarily driven by the personal beliefs and values of their owners. SMEs are also owner managed and highly personalized. This suggests differences in ethical behaviour by large firm and SMEs.

Painter-Morland and Dobie (2009) provide evidence to the effect that the most important ethical relationships in terms of business sustainability for SMEs are with customers and suppliers. These relationships have to do with trust and predictability. It is as important to be a trusted business partner as it is to have trusted business partners. Truly sustainable enterprises cannot only be honest in trade relationships; they also have to be honest in the internal administration, or governance of their enterprises. One of the easiest ways that SMEs break down their trust relationships is by not meeting commitments

Fassin (2005) and Lepoutre and Heene (2006:260) found that new SMEs experience more difficulties than their larger counterparts when engaging in socially responsible behaviour. The single most unethical practice by small business professionals is dishonesty in making and keeping contracts. In addition, lack of managerial kills and competencies limit the ability of new SMEs to run their firms and can reduce the trust of other parties. According to Hannafey (2003) and Mouzas et al. (2007), young firms face significant resource pressure. Thus liability of newness may lead new firms towards more individualist ethical postures such as non-repayment of credit. Hannafey (2003) further argues that although certainly the least quantifiable, ethics (which includes the character and personality) may well be the most important assessment that a lender can make about the prospective borrower. Regardless of the positive attributes of capacity, collateral and credit history that the borrower may have, if he does not demonstrate integrity and trustworthiness, any credit proposal may be declined. If the creditor senses that the borrower is somewhat untrustworthy toward fulfilling responsibilities with regard to the deal, even toward the business, the creditor will most certainly move away from the proposal. The lender must be made to believe that, in addition to the legal agreement, the borrower feels a certain moral obligation to repay the facility. Therefore, the subjectivity of business lending cannot be over stressed. Although, there certainly are concrete, quantifiable issues which the lender looks for, in the end, the decision whether or not to grant credit will often come down to subjective measurements, the comfort level that can be forged between the lender and the borrower. The implication of this is that credit is not only granted based on objective factors but also subjective factors such as ethical perception. This suggests that the ethical challenges faced by new SMEs may constrain the availability of trade credit.

RESEARCH METHODOLOGY

The study used the quantitative research design and survey research method. Data for the research study was gathered through self-administered questionnaires. The questionnaire consisted of primarily seven-point Likert scale questions ranging from strongly disagree to strongly agree questions except for demographic questions. The researcher focused on trade creditors in the wholesale, retail and manufacturing sectors. According to Selima (2007), these three sectors account for most of the trade credits. The population frame of trade creditors was obtained from the Border-Kei Chamber of Commerce, the Port Elizabeth Regional Chamber of commerce and the Enterprise Black Business Directory 2008. The population of big firms and SMEs that are in the wholesale, retail and manufacturing was five hundred and forty-one. Using the Raosoft sample size calculator at 5% margin of error and 95% confidence interval the sample size for trade creditors was 225. This is the minimum recommended sample size by the Raosoft sample size calculator. However, 315 questionnaires were distributed to trade creditors. The empirical research for the study was conducted in two ways; a pilot study and the main survey. Questions related to ethics are usually sensitive. Participants in the survey were assured strict confidentiality in order to obtain the necessary information. Sensitive questions such as the names and addresses of the respondents were removed from the questionnaire. Question items relating to ethics and finance were developed through the review of literature such as Howorth and Moro (2006) and Omolewu (2008). The Kolmogorov-Smirnov test was used to measure the normality of the data. According to Allison (2001) a missing value may represent or is a product of an unknown value. Pairwise deletion method was used to treat the missing values. Reliability and validity were ensured by pretesting the research instrument in a pilot study, comprehensively reviewing the literature for theoretical constructs and empirical conclusion and using the Cronbach's alpha. Data analysis for the study included descriptive statistics, Chi-square goodness of fit test, t-test and ANOVA

RESULTS AND DISCUSSION

Demographic Information and Availability of Trade Credit to New SMEs

A total of 315 questionnaires were distributed out of which 133 were returned. Most of the respondents were in the 31-40 age group. 73%

are males and 27% females. Most of the respondents were well educated with tertiary degrees and diplomas. 89% of the responding firms can be regarded as SMEs and 11% as large firms. Most of the firms have been in operation for between 11and 20 years. 64% are in manufacturing and 36% in wholesale and retail economic sectors. 122 respondents confirmed that they grant trade credit to other firms and 11 respondents confirmed that they do not grant trade credit at all. 88% of the respondents agreed that they have been approached by new SMEs to sell goods on trade credit and 93% agreed that they have rejected applications of trade credit by new SMEs. The results indicate that the rejection rates of credit applications of new SMEs by trade creditors are extremely high. According to Blumberg and Letterie (2008) the rejection rate of SMEs can be used as a proxy for the availability of debt finance to new SMEs. The extremely high rejection rates indicate low availability of debt finance to new SMEs.

Table 2 depicts the ethical factors why trade creditors reject credit applications from new SMEs. The seven-point Likert scale was used with 4 as the midpoint. The scale mean is 5.48. The Cronbach's alpha yielded a value of 0.729 indicating the reliability of the measuring instrument. Bad credit record has the highest mean of 6.85. Bad credit record is one of the ethical challenges faced by SMEs. This is followed by founder not familiar with the industry (6.82). Non-familiarity with the industry is a measure of ability. Other ethical challenges that constrain the availability of trade credit to new SMEs include lack of good reference on integrity with a mean score of 6.48. The perception of payment default (6.32), perception of dishonesty n keeping commitments (6.16), lack of experience (5.95), lack of business skills (4.25) and the perception of false information and paddling of financial statements (4.02)

The significance was tested through the non parametric chi-square of goodness of fit test as depicted in Table 3. The chi-square goodness of fit is the sum of the difference between the observed outcome and the expected outcome. The observed results however significantly reflects strongly agree and agree as depicted by the p-values. The results indicate that the ethical variables significantly constrain the availability of trade credit to new SMEs.

Table 2: Ethical challenges that constrain to availability of trade credit to new SMEs

Variable	*Mean*	*Standard deviation*
Bad credit record	6.85	1.57
Founder not familiar with the industry	6.82	1.07
Lack of good reference on integrity	6.48	1.39
Perception of payment default	6.32	1.07
Perception of dishonesty in keeping commitments	6.16	1.26
Lack of experience	5.95	1.42
Lack of business skills	4.25	1.69
Perception of false information and paddling of financial statements	4.02	1.31
Scale mean	5.48	
Cronbach's alpha	0.729	

Table 3: Ethical variables: Chi-square of goodness of fit test

Variables	*Chi-square*	*Significance level (p-value)*
Bad credit record	89.071	0.003
Founder not familiar with the industry	81.65	0.001
Lack of good reference on integrity	78.023	0.003
Perception of payment default	67.446	0.001
Perception of dishonesty in keeping commitments	61.929	0.001
Lack of experience	57.24	0.004
Lack of business skills	53.89	0.004
Perception of false information and paddling of financial statements	43.089	0.002
Scale mean	70.046	0.002

Sig. at > 0.05

Demographic Factors and Ethical Variables

The t-test was used to determine whether there are differences in the mean scores of male and female (gender) with respect to ethical variables (Table 4), ANOVA was used to test for differences in the mean scores of the age groups, education and product line. The results indicate that there is no significant difference in the mean scores of males and female students with respect to the ethical variables. The results furthermore indicate that there are no significant differences in the mean scores of the age groups, education and product lines (Table 5).

CONCLUSION

The results indicate that weak ethical perception of new SMEs is a constraint to the availabil-

Table 4: t-test results

Factors	*Gender*	
	τ	*Sig.*
Bad credit record	1.196	0.45
Founder not familiar with the industry	1.624	0.39
Lack of good reference on integrity	1.246	0.61
Perception of payment default	1.465	0.49
Perception of dishonesty in keeping commitments	1.929	0.76
Lack of experience	1.657	0.48
Lack of business skills	1.763	0.23
Perception of false information and paddling of financial statements	1.329	0.27

ity of trade credit. Howorth and Moro (2006) and De la Torre et al. (2008) suggest that ethics and trust are important in small firm finance. Trust mitigates adverse selection and moral hazard, reduces screening and monitoring costs. According to Shane and Cable (2002), ethics is very important for trade creditors. A large amount of transactions in inter-firm trade is done on trust and ethical perception. Such relationships are governed by norms of fairness and equity. In addition, trade creditors seldom take collateral in inter-firm trade. This increases moral hazard. Therefore, positive ethical perception and trust of the owners of new SMEs will positively impact on the availability of debt especially from trade creditors.

RECOMMENDATIONS

The results indicate that good ethical behaviour is important to a business in line with the Stakeholder theory by Freeman. Weak ethical perception is one of the major constraints to the availability of debt to new SMEs in South Africa. To improve ethics, unethical behaviours (such as deliberately not paying back debt) must be swiftly punished. Non-payment of debt will negatively impact on the credit history of the owners of new SMEs. In addition, owners of new SMEs that are unable to pay back their debt can use debt counsellors to help them restructure their debts as stipulated by the New National Credit Act. The legal system has to be made more efficient through quick court judgments. There is the need for a campaign by the government to change the minds of the people that unethical practices are bad. Business ethics should be introduced as a major module in the universities and colleges in South Africa to prepare likely entrepreneurs about the importance of ethics in business. SME owners should be trained on the importance of business ethics. Governmental and professional business entities should provide proficiency training that is grounded in sound ethical management. The South African government and agencies responsible for SMEs such as the Small Enterprise Development Agency (SEDA) needs to actively promote organizational ethics by developing and sponsoring legislation that supports socially responsible business practices.

It is also important for SMEs to identify and define the core values of the business. In SMEs, these values will inevitably be influenced by the personal and professional values and principles of the owner-managers. Employee involvement can increase the effectiveness of an ethics policy. In addition, it is necessary for new SMEs to draw

Table 5: ANOVA results

Factors	*Age*		*Education*		*Product line*	
	F	*Sig*	*F*	*Sig*	*F*	*Sig.*
Bad credit record	0.860	0.425	0.727	0.284	0.426	0.357
Founder not familiar with the industry	0.940	0.262	0.836	0.167	0.521	0.333
Lack of good reference on integrity	0.629	0.323	0.766	0.365	0.577	0.519
Perception of payment default	0.498	0.197	0.721	0.377	0.215	0.228
Perception of dishonesty in keeping commitments	0.766	0.256	0.497	0.218	0.379	0.228
Lack of experience	0.455	0.192	0.837	0.329	0.856	0.395
Lack of business skills	0.639	0.277	0.474	0.281	0.538	0.271
Perception of false information and paddling of financial statements	0.419	0.247	0.326	0.266	0.222	0.273

up a code of ethics. A code of ethics is the main tool for implementing an ethics policy. It translates core values into specific commitments and expected behaviours in relation to the organization's key stakeholder groups (that is, customers, employees, suppliers and contractors, providers of finance and community).

In order to improve managerial competencies and skills and thus enhance ability, there is the need for personal development by the owners of new SMEs especially in the area of business and financial management skills through training. Government agencies such as SEDA and Development Corporations can organize training for new SMEs. Awareness should be created for the training programmes through advertisements in local and national media. In addition, entrepreneurs need to attend seminars and trade fairs and also join trade associations. Networking can assist in improving managerial skills and integrity of new SME owners.

V. LIMITATIONS AND AREAS FOR FURTHER RESEARCH

The study focused on the perception of trade creditors and did not seek the perception of the owners of new SMEs (demand side) about the impact of ethical challenges on access to external finance. A dyadic study to investigate the perception of both the demand and the supply sides about the impact of ethics on finance will significantly contribute to existing literature in the area of business ethics. In addition, the impact of other social factors such as crime and corruption on access to external finance are areas worth investigating.

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