Because of their size, the value of transactions SMEs execute is small in magnitude (Vandenberg, 2003), leading to higher transaction cost. They apply for relatively smaller amount of bank loan. Banks, on the other hand, prefer loans that are large enough to generate income that covers administrative costs and allow a profit. Banks therefore consider SME loans less profitable and find little incentive in lending to them, and when extending credit they charge higher interest. In the worst case, they set a minimum loan size, beyond what SMEs can afford, thereby cleverly excluding SME lending.

2.2 AVERSION TOWARDS DILUTION OF OWNERSHIP INTEREST

Most SMEs are established within family or friendship group. Theory predicts that insider sales of ownership interest tends to convey bad news as they suggest a dwindling of insider’s incentives and a lack of insider confidence on business prospect (Livingston, 2007). Empirical studies, however, show that SME operators dislike selling interest to avoid monitoring by outsiders. Besides, the founder may derive utility from his ability to “exercise authority, dictate strategy, and choose which investments the firm will undertake” (Schulze et al, 2003:179). The controlling managers in small firms exhibit a good deal of apparently defensive behavior and as reported by Livingston(2007), managers in firms with substantial family involvement tend to hold higher stakes in their firms and are less likely to break them up. Wu et al (2007) in their survey of family businesses, found that financing decisions of family firms involve a trade-off between family control and the pursuit of growth opportunities. They also show that a highly levered capital structure or limiting growth allows the family firm to maintain control and pursue complex objectives. In addition, family involvement decreases the use of monitoring by both the board and non-family financial managers.

The fact that SME operators detest dilution of control often limits their financing ability and also their growth. Independence and control are often considered the primary reasons for the differences in SME financial behavior compared to what might be expected from the publicly listed firms. According to Vos et al (2007) SMEs exhibit signs of financial contentment, showing that SME owners like to sustain their firm and do not seek growth beyond their ability to control. They claim that financial contentment as a financing pattern describes much of the SME sector. SMEs seeking growth, however, participate more in the external capital markets than those not seeking growth. Small firm owner’s control averse behaviour limits SME financing alternatives increasing their reliance on bank credit. This is confirmed by Carey & Flynn (2005) who found that there is a high degree of Irish SME dependence on banks as a source of funding.