

Impact of Strategic Networks for the Success of SMEs in Sri Lanka

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The purpose of this research paper is to shed light on the structure of social, inter firm and supporting networks of SMEs in Sri Lanka and identify the impact of networking for their success. At present most of developed countries gain immeasurable opportunities and advantages through the network relationships among SMEs. The findings revealed that when the SMEs are identifying their business opportunities, they closely link with their families and friends. In the start up phase, SME owners gain encouragement, influence and initial capital through the social networks. But in Sri Lanka, there was a poor relationship with the supportive and inter-firm networks. Conversely, there was a strong impact of network relationships for the success of SMEs in Sri Lanka. Therefore, the policy makers, socialists, donors and others should promote the network formation approaches, by organizing network activities for SMEs, apart from their traditional supporting approaches.

Field of Research: Management of Small Business, Economic Development and Policy

1. Introduction

The Small and Medium Scale Enterprises (SMEs) were enormously abandoned and disregarded in the period of 1950s and 60s due to the encouragement and upheld of large enterprises (Stokes 2003). However, this has created much intimidation for many countries specially for developing countries since this type of strategies do not address the major economic problems such as unemployment, low income and poverty (White Paper: Task Force 2002).

Therefore, in 1970s and 80s the situation changed and SMEs became very momentous part in an economy. They played a critical role in generating new employment, economic growth, innovation, competition and poverty reduction (Stokes 2003: and Prasad 2004). According to the International Finance Corporation (2006), SME contribution to the Gross Domestic Product (GDP) and the employment has been gradually increasing. Also SMEs increased their resource and exports from the liberalized economic policies and foreign direct investments (Raynard and Forstater 2002).

Besides, the internationalization of economy, globalization of trade, growth of internet and information technology created many changes among every country in the world and competition became rampant for gaining sustainable growth in the world (Prasad 2004: and Johnson and Scholes 2005). This was greater for SMEs because their economies of scale, inadequate access to capital and finance, inadequate industrial infrastructure, lack of market base information, obsolete technology, lack of modern management skills and lack of labour training are less than large firms (Antonio and

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Gregorio 2005). Due to that, the annual closures rates of SMEs in developing countries were gradually increasing.

It is certain that SMEs need the support and resources from the external parties, who are not directly employed in the firm such as other firms, supporting institutes, relatives and friends (Baird, Lyles and Orris 1993: and Birley 1985). If an organization can network with its suppliers, buyers and competitors, it will become a crucial ingredient to avoid competition and achieve the advantage (Johnson and Scholes 2005). Through these network relationships, companies can identify their opportunities and try to raise their resources, competitive advantage, efficiency and profits by avoiding competition among them (Stokes 2003: and Berry 1997).

In this research paper, researcher discussed the problem relating to the SME success, the importance of strategic networks and the objective of the study. Then, the researcher presented networking as a strategy to overcome the problems of SMEs and some selected network approaches and models. These approaches provide rationale, analytical base and structure for this study. Under the research methodology, research design, sampling, method of data gathering, analytical techniques and the hypothesis were emphasized. Next, data were analyzed and discuss the findings. Finally, the researcher concluded the study by contributing to the body of existing knowledge.

1.1 Research Problem

Strategic alliances, business collaborations and networks are becoming popular among the SMEs due to the competitive advantage and ability to share resources and capabilities with other firms by gaining economies of scale through joint purchase, bundling of lot size to serve large customers, joint market activities, joint product development and help in research, reduced lead time for deliver, built joint information system and reduced stocks (Johnson and Scholes, 2005).

Number of studies (Butler and Hansen 1991, Lechner and Dowling 2003, Berry 1997, Oughton and Whittam 1997: and Premaratne 2001) have given evidence that the importance of networking for SME success and economic development. Even much research were done in entrepreneurial networks in developed countries, little attention had been given to developing countries. Therefore, it is necessary to understand the role of SME networking in developing countries. In this research bridge this gap by scrutinizing the impact of SME networking for the SME success in Sri Lanka.

As a result, this study attempts to address the following research questions:

- How do SMEs set up their networks with external actors?
- How do network actors differ in each phase of the SME?
- What is the role and impact of networks for the SME success?

1.2 Research Objectives

Thus, this research aims to achieve the following specific objectives:

- To identify the formation of networks among SMEs
- To explore the important network actors in each phase of the SME
- To examine the role and the impact of networks for the SME success

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1.3 Significance of the Study

Although, most of empirical studies have been conducted in developed countries, only a few engagements were carried out in developing countries, which were significantly low in countries like Sri Lanka. The focus of this research is on the informal network relationships and the success of SMEs in Sri Lanka.

2. Literature Review

There is no particular, apparent and universally accepted definitions for SMEs and such definitions vary from country to country, sector to sector and even among institutions within the country (Storey 1994: and International Finance Corporation 2006). According to the Hallberg (1999) “the small and medium-scale enterprises are a very heterogeneous group. They include a wide variety of firms which possess a wide range of sophistication skills and operate in very different markets and social environments”.

SMEs are different from large firms by uncertainty, innovation and evolution while they are operating their business in more uncertain external environment than large firms and they are more talented to introduce new products than large firms. The World Bank defines small businesses as the businesses, which have fewer than 49 employees and medium scale businesses as the businesses, which have 50 – 90 employees.

The SME owner/managers need the external focus to build up a successful enterprise, but they forget to carry on it when they run the business. On the other hand, these firms need more resources to compete in the business environment so they need help and support to compete and survive in their business (Baird, Lyles and Orris 1993: and Birley 1985). The idea of networking is to sustain the success of SMEs by dealing with their deficiencies, because the empirical studies have identified that the corporative strategic networking in one of the best solutions and it can be used as a strategy to give mutual support for each SME owner/manager, collaborate with large organizations and gain assistance from local institutions such as chamber of commerce (Johnson and Scholes 2005).

The researchers mentioned that the networking is a specific set of relationships among the various actors (Berry 1997: and Ougton and Whittam 1997). According to Hoskisson, Hitt and Ireland (2004) a strategic networking is a grouping of organizations that has been formed to create value through participation in an array of cooperative arrangements, such as alliances and joint ventures. In this study, networks are defined as SME owner/manager’s personal relationships with his external actors or outsiders (Dubini and Aldrich 1991, Berly 1985: and Premaratne 2001). Then again, it is defined as the long-term relationship between SME owner/manager and external actors (persons or organizations) due to attain the information, support and other resources.

Researchers have shown that the SMEs maintain two types of network relationships. First one is social network relationship and it contains family, relatives, friends and acquaintances. Next one is organizational networks and it consists with supporting networks such as government bodies, Non-Governmental Organizations (NGOs), banks, other SME supporting institutes and inter-firm network relationships such as

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relationships with large organizations or SMEs. All these relationships are important for the SME success (Berry 1997: and Ougton and Whittam 1997). Consequently, external actors of a firm can be individuals or organizations. They are not directly employed in the organization (Chu 1996, Dubini and Aldrich 1991, Berly 1985: and Premaratne 2001). SME owner/manager builds up these relationships to perform activities and attain resources. Therefore, SME networks consist of four major elements: actors, resources, activities and linkages.

However, relations inside the SMEs, between the enterprises and environment are more personal and less organized. Donckels and Lambrecht (1995 cited in Premaratne 2002) stated that external consultants, trade fairs, seminars, contacts with other SME owner and discussion with relatives are important sources for the personal network formation. Also they studied that the impact of the personal network formation for the growth of SME and results confirm that the networks formation significantly influenced the SME growth. Conversely, organizations exchange and carry out transactions with other groups or organizations. This may involve information, monetary or physical resources because SME owner/mangers are not self-reliant (Prasad 2004).

The Resource Dependency Approach (RDA) used to understand the behavior of an organization in relation to its external environment. The external environments of firms are important for understanding actors of networks. According to the RDA, success of a firm depends on resources and supporting networks. The resources and supports are, mostly for SMEs, forbidden by external actors of the firms (Pfeffer and Salancik 1978 cited in Premaratne 2002). The Social Network Approach (SNA) establishes at the point where two people begin a relation or transaction. Individuals in any society engage in numerous social relationships with others (Chu 1996, Birley 1985: and Butler and Hansen 1991). Hakansson and Snehota (1995 cited in Premaratne 2002) pointed out the four basic elements of Swedish Network Model (SNM); (1) actors, (2) activities, (3) resources and (4) linkages.

The network evaluation model explicates that the different types of network relationships are needed to development different phases of a firm. The early stage of a firm is the entrepreneurial phase and social network relationships are major in that phase. In the business start-up stage, the business focused network relationships are more crucial. Finally, strategic networks are essential for on-going phase of the business (Butler and Hansen, 1991). Similarly Sengenberger *et al.*(1991 cited in Premaratne 2002) noted that 'the firm looks for other SMEs to associate with and to build a more permanent, mutually constructive network of joint support and resource sharing, possibly with the coordinator specialization of each firm in the network'.

Consequently, most of research have identified that the impact of social networks highly significant for the propensity of an individual to become a SME owner/manager. According to Butler and Hansen (1991), the SME social network is like an opportunity set. Therefore, individuals' social network can have an impact on the decision to start a business (Chu 1996), but strategic network is needed for the on-going success of a firm (Butler and Hansen 1991: and Birley 1985). They pointed out that social and strategic networks provide successful start-up and lifelong competitive advantage.

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Chu (1996) scrutinized how members relate to a network and how networks developed in different phases of the organization and it shows that different networks are important in different phases of the organization and they give support for the business success. Accordingly, the scenery of the networks differs in each phase of a firm whilst, the role and impact of the networks also differ due to the different problems face by the firms in different phases and in each phase a firm will have different demands and different resource requirements (Butler and Hansen 1991).

3. The Methodology and Research Design

The data in this study were subjective and multiple as perceived by the participants in a study. Thus, a combination of quantitative and qualitative methods was used to analyze research problem. The identification of various social and organizational networks was significant for analyzing the relationship between these networks and SME success. This represented the descriptive content of the study. The explanatory part in the study was the relationship between networks and SME success.

The population of this study consisted of SMEs operating their businesses in Sri Lanka. Concentration on entire country was very costly and a representative sample of SMEs used. The technique was the non-probability sampling method and the purposive sampling technique which was one of the methods to do non-probability sampling. Based on that, sample was randomly selected from the SMEs in Gampaha district where the second highest number of industries are established in Sri Lanka.

In Gampaha district, the major areas of the manufacturing are food and beverages, wood and wood products and construction materials. Therefore the operational population of the study was SMEs in Gampaha district. Due to practical difficulties such as money, time and transport sample was restricted to 50 SMEs. The response rate of this study is 100% due to the data collection method. By considering the limitations of each method and the research objective it is decided to conduct face-to-face interview instead of other methods. The high rate of response, ability to exercise control over context of the questions answering, high accuracy and completeness of response to questions are the advantages of this technique.

A well-prepared structured questionnaire was used as a tool to maintain the conformity of the interviews. The time period of this data is the business organizations registered and operated from year 2006 to 2008. Also researcher was personally involved in the interviews in order to clarify certain events of the firm. In addition to that secondary data was also used to enhance the interpretation of the outcome. The questionnaire consisted of two parts. Part one covered the background information about the SMEs and the second part was used to identify the SME networks and their impact on the SME success. The descriptive statistic and bivariate correlation was used to test analyze the data. Through that an attempt was made to find out whether there was a relationship between the networking and SME success. Data analyzed using Statistical Package for Social Sciences (SPSS) 14.0 version. A pilot survey increases the validity and the reliability of a research. In this study, a pilot survey was conducted for 7 SMEs to test the questionnaire and data gathering was started with the pilot survey.

Several studies have mentioned that the greater number of network relationships will provide more support; the factors considered were information, case, moral and other

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resources for the SME owner/manager as they can gain access to more resources through their network members. Therefore the size of SME network was the independent variable to explain the SME success. The network size was obtained by asking respondent to state the approximate number of actors with whom they deal with for business and supportive activities such as business plan discussion, financial support, information and any there resources. This refers to the number of links between an organization and outsiders. Social networks consist of actors such as family members, friends, and associates whereas supporting networks consist of supporting agencies such as banks, government agencies and NGOs and the inter-firm networks include other enterprises both large and small. In this way, actors of the supporting networks and the inter firm networks are generally considered as organizations.

Dependent variable was the business performance of the firm and it was measured through the sales growth, business progress and last year financial result. But most of SMEs in Sri Lanka do not maintain financial reports properly. Therefore, their past year experiences, present situation and the future expectations were used as relevant factors. Then those data were used to analyze the hypothesized relationships.

Previous studies (Chu 1996: and Birley 1985) showed that SME owner/managers mostly depend on their personal networks as a supplement for their resources and they are the most valuable asset. Therefore the research hypotheses were as follows:

Hypothesis A: Discussion with family, relatives and friends has a positive impact on the business performance

Hypothesis B: The participation for the trade fairs has a positive impact on the business performance

Hypothesis C: Attending seminars has a positive impact on the business performance

Hypothesis D: Obtaining external consultancies has a positive impact on the business performance

Hypothesis E: Membership in various associations has a positive impact on the business performance

Hypothesis F: The contacts with other SMEs have a positive impact on the business performance

Hypothesis G: The links with competitors have a positive impact on the business performance

Hypothesis H: Meeting with the firms (in the same field) has a positive impact on the business performance

Hypothesis I: Meeting with the firms (not in the same field) has a positive impact on the business performance

4. The Findings and Discussion

According to the data analysis, 94% of SME owner/managers are males thus it is evident that majority of business owners are still males despite the noteworthy increase in the female employment in the country. Even the majority of industries are established in urban areas most of the SME owner/managers came from the rural area. With regard to the age distribution, it is evident that most SME owner/managers start their business careers between the ages of 30 to 49 and their average age is 44 years. Only 10% of SME owner/managers belong to the age above 60 years and 4% of SME owner/managers drop into age below 30 years. Most of SME owner/managers have below 20 years of business experience and the average business experience is 17 years while 30% have less than 10 years of business experience.

G.C.E. Ordinary Level education account for 24%. Nearly 26% of SME owner/managers have passed only the G.C.E. Ordinary Level education and not G.C.E. Advanced Level. Out of total respondents, 46% of SME owner/managers have passed the G.C.E. Advanced Level education.

According to the analyzed data, the most important source of attaining technical skill for majority of SME owner/managers was on the job training. 56% of them said that they obtained required technical skills on self study basis. Apart from that the other important sources of obtaining technical skills are their former job and family tradition and the percentages are 22 and 10 respectively.

In comparison to that, the main source of obtaining management skills is also on the job training and the percentage is 36, followed by family tradition (18%), then by former job (12%). Remarkably, almost all the SME owner/managers responded that they have not acquired much of their skills from the formal training course (schools and technical institutes). Most of them have worked either for other small firm or public sector and nearly 66% of SME owner/managers have had any kind of an experience before they started their existing business.

The major areas of the manufacturing were food and beverages and chemical products. These two areas were held 18% from the total firms. Secondly, the wood and wood products were major and it carries 16% from the total firms. 12% of firms are in the category of construction materials and rubber and plastic products hold 10% from the total. Out of total firms both agro- base products and leather and leather products reported 8%.

The relative size of the SME networks also gives a basis for this study and it was given in the Table 1 below. According to the table, the social networks were represent a huge difference when comparing to the other three; the major reason for this was several social network members fall into the other two networks too, but they like to identify them as social network members due to their social relationships and most of them were their relatives and friends though they work for different firms or supporting institutes.

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**Table 1:
Relative size of the SME networks**

SME networks	Percentage (% of total actors)
Social networks	86
Inter-firm networks	10
Supporting networks	4
Other	0

Source: Computed data

Almost 96% of SME owner/managers responded that they communicate their business ideas with their family members before starting a new business and 42% of them reported that the importance of their family members was very great at the business identification phase. The second important network actors for this phase were friends and their percentage is 42%. But, their importance is below that of the family members as they reported that the importance is great.

Based on the data, it is evident that in the start up phase also respondent agreed that the importance of the family members was very great (54%). SME owner managers agreed that the importance of friends is also high when starting a business (42%) from the total respondents. In addition to that, 32% of SME owner/managers agreed that the bank and finance institutes are important in the start up phase.

When considering the running phrase of the business the data showed that the banks and finance institutes were important and almost 66% of respondents reported that they obtain support from the banks and financial institutes when running the business. It is interesting that the importance of family members was not very much important as the banks and finance institutes.

It is critical that the other actors: teachers/ professional, other firms, government bodies, NGOs and Chamber of Commerce were not very important in the above three phases of the business.

**Table 2:
Relationship between network actors and the resources**

	Social network	Inter-firm network	Supporting network
Financial	76%	28%	8%
Technology	12%	42%	32%
Labour skill development	16%	58%	46%
Marketing and market information	14%	82%	24%
Consulting/discuss business matters	66%	48%	34%
Production process	22%	54%	12%
Raw material supply	32%	68%	6%
Transporting	36%	46%	28%
Subcontracting	12%	84%	24%
Other non material support	68%	44%	36%

Source: Computed data

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Table 2 depicts that respondents have relationships with others for several reasons. Their social networks provide 76% of financial support and it is the most important resource that they received from them. Other non-material support was the second highest resource (68%). 66% of respondents said that they obtained advice from their social network and it was also a resource for them.

Through the inter-firm networks, 84% of respondents believe that they obtain subcontracting and 82% replied that marketing and market information is the important resource in the second place, followed by raw materials (68%). Amazingly, the importance of supporting networks was considerably at a low level than the other network of actors.

**Table 3:
Relationship with network factors and business performance**

	The present sales performance of the firm	The present progress of the firm	The financial results for last year
Discussion with family, Relatives and friends	.627**	.874**	.763**
Attended any trade fairs national or international	.361*	.413**	.461**
Attend any seminar last year	.466**	.380**	.424**
Got the external consultation about the business	.221	.371**	.321*
Membership in any professional association	-	-	-
Regular business contacts with other SMEs	.323*	.570**	.402**
Any links with major competitors	.367**	.663**	.533**
Frequency of Meeting with the firms in the same field	.331*	.486**	.418**
Frequency of Meeting with the firms not in the same field	.079	.122	.091

**Correlation is significant at the 0.01 level

*Correlation is significant at the 0.05 level

Source: Computed data

As pointed out by the Table 3, discussion with family, relatives and friends has a positive impact on business performance of the firm at the 0.01 significant levels. The relationship between family, relatives and friend and the sales performance was more

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than 60%. Also the link between family, relatives and friend and the present progress of the firm was more than 80% while the financial result was 70%. Therefore the collected data supported and accepted the hypothesis A.

The participating for trade fairs has a positive impact on the performance at a 0.01 and 0.05 significant level (Table 3). Therefore the hypothesis B can be accepted, but the relationship was not much powerful, because the correlations with sales performance, present progress and financial result were below 50% of the relationship with trade fairs.

Attending seminars has a positive impact on business performance of the firm. Therefore the hypothesis C can be accepted at the 0.01 significant levels. However, this was also not very strong because, the table 3 indicates the relationships with sales, progress and financial results where those figures were between 35% and 50%. Moreover, obtaining external consultancy also has a positive impact only with the past progress which was 0.371 and the financial results of the firm which was 0.321, but not on the sales due to the weak relationship (0.221). Hence, the hypothesis D can be accepted.

The hypothesis E cannot be accepted due to the relationship between membership of any kind of association and the business performance is weak. The respondents of questionnaire did not have any kind of a relationship with the different member associations, due to that the collected data was not relate with this hypothesis. The regular business contact with other SMEs has a positive impact on the past progress of the firm which was 0.570 and it shows somewhat stronger relationship than the financial results and the sales performance. Therefore the hypothesis F can be accepted.

The relationship with major competitors had a strong positive impact on the present progress and the financial result of the firm they were 0.663 and 0.533 respectively where the correlation is significant at the 0.01 level. This positive relationship was not strong with the sale performance still the hypothesis G can be accepted due to the overall positive relationship.

Further this table 3 explained how regular meetings with other firms who are in the same field have an effect on the business performance at the 0.01 and 0.05 significant levels. Therefore the hypothesis H can be accepted. The hypothesis I cannot be accepted due to no significant relationship between meetings with entrepreneurs in different fields and the business performance which was only around 10% for all the three business success factors.

4. Summary, Conclusions and Limitations of the Study

In the start-up phase SME owner/managers need encouragement, influence and initial capital and they gained that through the social networks. But in later business focus networks are dominant. Finally in the on-going phase strategic networks are important to reduce risk. Also it was found that family and friends are the main source of initial capital.

Most of SME owner/managers are looking for external consultancy only when they have a financial problem, market problem or sales decline problem. Furthermore

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there is an impact of discussion with family, relatives and friends. There is an impact of participating in trade fairs and seminars. Once they attend seminar or trade fairs they will be able to identify national or international buyers and subcontractors. However, when they attend any trade fair or seminar they have to wait two three years to harvest the result.

There is an impact of regular business contacts with other SMEs. Through their regular business contact they expand their sale and market opportunities. Besides, there is an impact of relationship with major competitors on SME performance. Most of the time, the entrepreneurs do not know how are our competitor will react.

There is an impact of relationship with entrepreneurs who are in same field because by using their resource SME owner/managers can increase their business performance. In this study considerable network relationship was not observed with international firms. This could be, because most of the international businesses are located mainly in Colombo area and Sri Lanka has to develop international networking.

The analysis of the impact of networking for the SME success in Sri Lanka revealed that the network formation is a crucial aspect of SME development. Therefore, networking becomes an important element in the growth of SMEs. However, according to the SME owner/managers point of view the formal network relationships are experienced-based, time-consuming activity.

In this study, the analysis of data, interpretation of the findings and the conclusions were subjected to a number of limitations. In the methodology, major limitations were the measurements of variables and bias in data. Both business matters and family matters were difficult to identify separately in the context of family relationship.

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