

Financing Problems and Solutions of SMEs

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Abstract

SMEs (Small and medium-sized enterprises) make great contributions for the development of the Chinese economy, but it's very hard for SMEs to get capital raising service from stock markets and banks when they need money for its operation. This paper tries to analyze the external and internal reasons for this phenomenon and gives some suggestions for possible solutions.

Key words: Direct financing; Indirect financing; Private finance

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INTRODUCTION

SMEs (Small and medium-sized enterprises) are the most important constituent part of a country or district, and are the engine of economic development. In developed countries SMEs account for 97% of the total number of enterprises. The degree of contribution to social employment and the economy is over 50%, but fund raising for SMEs is a problem throughout the whole world. Problems of fund raising become a strong constraint for SMEs. According to the new criteria for the classification of SMEs and the second economic

census data estimates, SMEs account for 99.7% of the total number of enterprises in China. They create 60% of the GDP, supplying more than 80% of employment opportunities in cities and towns. According to calculation, more than 65% of patented inventions, 75% of enterprise innovations, and 80% of the research and development of new products are accomplished by SMEs. Above all, SMEs make a great contribution to the development of the Chinese economy, but it is very difficult for SMEs to borrow money from financial institutions. According to the International Finance Corporation's research data, Chinese small and medium-sized enterprise capital and internal retained earnings accounted for 30% and 26% of the sources of funds of enterprises, respectively. Money from relatives and friends accounts for a large proportion of the endogenous financing of enterprise. But exogenous financing like money from banks and stock exchanges is very rare. Zhen (2013) pointed out that finding the solutions to the problem of enterprise financing is an urgent and important task for China. Liang (2005) investigated the development and financing status of SMEs and made a comprehensive exposition of fund raising problem of SMEs from the view of development history, finance management, finance structure, operation and service supplied by financial institution, and credit guaranty institution. Chen (2006) investigated financial means of different development decades of SMEs and found that the financial structure of SMEs changed with the different development decades, and the trend of change is periodic. Jiang (2004) analyzed the theory of private finance, and then he proposed that our understanding to basic problems of private finance was the specific explanation to the transition of financial institutions. Li (2009) analyzed the internal and external environment of fund raising problems of SMEs and proposed that microfinance is a solution to this problem.

Table 1
The Proportion of SMEs That Obtain Loans From Financial Institutions (%)

	Small enterprises	Medium enterprises	Large enterprises
Low income countries	16.70	35.70	47.80
Middle income countries	31.80	45.60	59.30
High income countries	47.70	62.20	68.90

Note. Adapted from "Small enterprise financing: international comparison, experience and Chinese measures," by C. M. Jing, 2013, March, Retrieved from <http://www.cciee.org.cn/expert/NewsInfo.aspx>

As Chinese marketization is different from other countries in economic system and environment, this article analyzes the constraints of SMEs' financing problems from the perspectives of market system and environment and tries to find the solution to these problems.

1. THE ANALYSIS OF INTERNAL AND EXTERNAL REASONS OF SMES FUND RAISING PROBLEMS

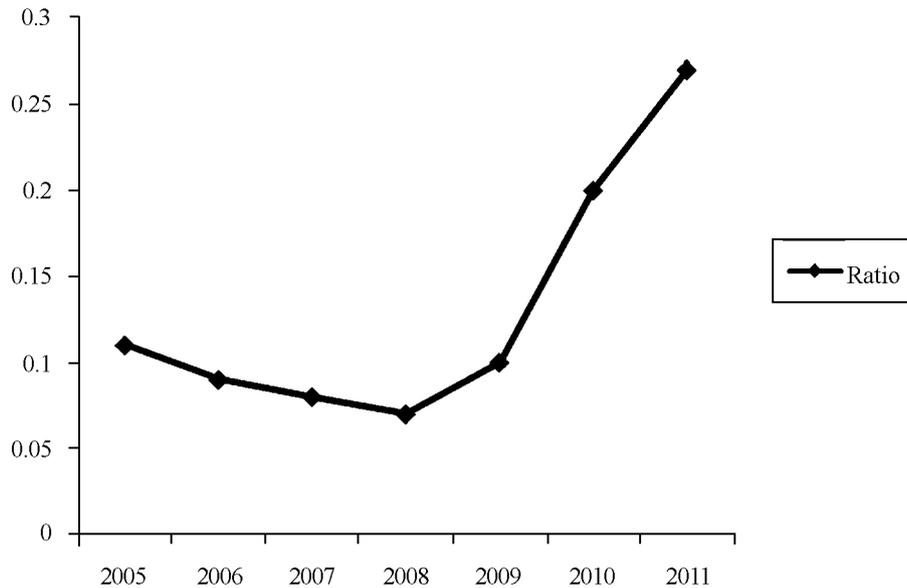


Figure 1
The SMEs Loan Ratio of Short-Term Loans

Note. Adapted from "Improving the Financing Environment of SMEs," by W. Xie, 2011, March, Retrieved from <http://www.buiness.sohu.com/20111031/n323950080.shtml>

From the graph above we can see that the SMEs loan ratio of short-term loans is very low. Although the situation was improved after 2010, the ratio is very low still. In response to this phenomenon, this article distinguishes between internal and external environments when discussing the financing environments.

1.1 External Environment

Fund raising is classified as direct financing or indirect financing from the external environment when enterprises obtain capital by issuing shares or bonds in the financial market, also known as direct fund raising; enterprises borrowing money from financial institutions is called indirect financing. Both direct financing and indirect financing are difficult for SMEs in China.

Firstly, the system for quoted companies is authorized system so that it is very different for SMEs to issue shares or bonds in China. As a result, SMEs can hardly obtain money from capital market. Although the government established the GEM (Growth enterprise market) in 2009 after preparing for over 10 years, but as the GEM has

been launched for only a few years, the scale of it is very small and the risk of GEM is relatively high. As a result, institution investors don't like to put their money in GEM and this phenomenon restricts the fund raising ability of GEM greatly. On the contrary, more than half of American SMEs can get help from the risk capital and 8% of high-tech enterprise capital is obtained from risk capital. It is the existence and involvement of large community funds like pension funds, unemployment insurance funds, and a large amount of professional risk investors that make great contribution to the development of the American risk capital industry and meet the needs of American SMEs to raise money. Many shortcomings of the regulations of capital market make it difficult for SMEs to obtain capital from the capital market in China.

What's more, on the level of indirect financing, most financial institutions in China are commercial banks; maximized profit is the aim of commercial banks. The banking industry is allowed a very high degree of monopoly in China. Commercial banks get to benefit from the rate gap between saving and loaning stipulated

by Central Bank and loaning money to large state-owned companies. Loaning money to SMEs will cost more money, due to cost associated with the collection of management information and capital information of the enterprise, than loaning to large state-owned enterprises. Additionally, when comparing to loaning to large state-owned enterprises, loaning to SMEs will produce less profit while providing more risk.

1.2 Internal Environment

From the perspective of SMEs, there are also some loopholes in the system of enterprise. These loopholes destroy some necessary conditions for SMEs to borrow money from financial institutions. There are two main reasons for this destruction: the information system of SMEs and the capital structure of SMEs.

In regards to the information system, as we know, the operation of enterprise should be reflected by accounting and financial statements. But many SMEs do not have enough transparency of the daily management information, SMEs' management information systems are usually inadequate, some SMEs even don't establish management information systems at all. As a result, financial institutions, especially banks, can't get reliable information of enterprise capital liquidity. Some small and medium-size enterprises don't establish standard accounting procedures because of a lack of trained personnel or tools. But for banks, a lack of transparent and reliable accounting information makes it hard to control the potential risk of enterprise. In addition, banks don't want to go into business with SMEs because of the opacity of enterprise credit information and disorder of their credit record.

Except transparency of information, adequacy of owned capital is another key factor influencing the decision of whether or not a company can borrow money from bank successfully. Some SMEs have very low adequacy of owned capital and some only just meet the needs of regulations. This situation causes two problems. The first problem is that inadequacy of owned capital leads to the failure of daily operation of enterprise and owned capital can only meet a part of capital need, therefore enterprises have to turn to banks to borrow money. The other problem is inadequate owned capital also makes it so that enterprises do not have enough debt capacity, in the actual operation, banks don't satisfy the mortgage capacity of SMEs, then they don't want to loan money to SMEs.

2. EXPLOITING THE SOLUTION TO SMES FUND RAISING PROBLEM

In response to the constraint of SMEs' fund raising from internal and external environment, this article supplies the following solutions:

2.1 External Environment

2.1.1 Promoting the SMEs Fund Raising Problem from Capital Market Level

From the perspective of external environment, the direct problems for SMEs are that they have virtually no way to obtain money from the capital market by issuing shares or bonds. This phenomenon greatly restricts the development of SMEs, The authorized systems at present make it hard for SMEs appear on the capital market. Even some successful large enterprises have no access to capital market. The Chinese government could try to reform this system by using a registration system instead of an authorized systems. If this reform can be realized, it will improve the condition of SMEs' fund raising greatly. Whether registration system or authorized system is in place, publishing enough information is the most important thing. We think that we should not set the threshold for enterprise to step into the capital market too high but should concentrate our efforts on incentive measures, penalty system, and supervision. On one side, we should let more SMEs raise money from the capital market, on the other side, we should punish the enterprises which appear on the capital market by dishonest means.

At the same time, the government should accelerate the construction of a second board. Most SMEs can raise money from NASDAQ (National Association of Securities Deal Automated Quotations) market. Although China launched GEM at the end of 2009, the GEM also has problems: unevenness of the listed companies, lack of leading enterprises, low liquidity of the auction trading system, and a very small session which is easy to be manipulated and causes excessive speculation. As the important capital market for SMEs to raise money, GEM should establish a good rating system and select the listed companies rigorously. They can introduce market-maker system and combine it with auction trading system. At the same time, government should try their best to let the powerful risk institutions and investment institutions enter the GEM and they should establish a strict punishment system to penalize the persons who manipulate the stock exchange. The person who manipulates the stock exchange should lose more than they get. Finally, government should also improve legislation and develop appropriate laws and regulations to establish a good legal system to make the GEM a good market for SEMs to raise money.

2.1.2. Developing Private Finance, Legalizing and Regularizing Private Finance

Indirect financing is particularly important for the development of SMEs when SMEs can't obtain capital through direct financing. Due to the monopoly position of state-owned commercial banks, the state-owned commercial banks can earn great profit from the rate gap between savings and loans and going into business with large state-owned enterprise. Loaning to SMEs produces problems like high cost, low return, and so on. As the

profit-nature of capital, state-owned commercial banks don't want to go into business with SMEs. I think if we want to solve the financing problem of SMEs, developing

private finance is the most important. Only through legalization and regularization the private finance can we solve the fund raising difficulty effectively.

a. The development and models of private finance

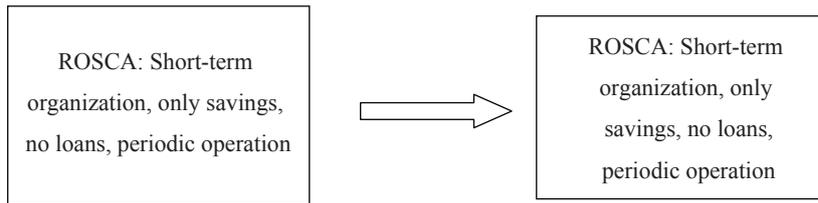


Figure 2
Development Trend of Private Finance (one)

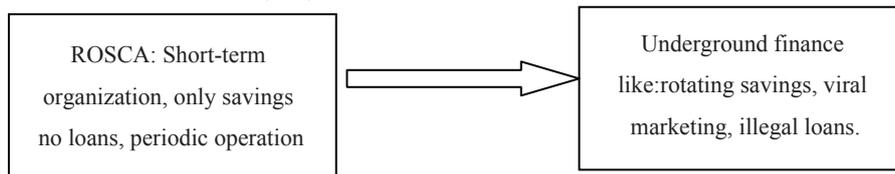


Figure 3
Development Trend of Private Finance (two)



Figure 4
Development Trend of Private Finance (three)

Reviewing the development trend of private finance, the initial stage of private finance is always the mutual-help financial organization; ROSCA (Rotating Savings and Credit Association) model is the most typical mode. As Chinese market economic development only has 35 years of experience, the degree of marketization is not high, so mutual-help organization is a suitable mode for enterprises on the initial stage. Members of the mutual-help organization can get financing help from the mutual fund when they need. Private finance will turn into profit-making finance and permanent institution as the degree of marketization becomes higher and higher. At present, China doesn't have relevant laws to protect private finance and private finance doesn't have access to social savings. This restricts the development of private finance very much. A lack of standardization will lead diseconomies of scale. To improve these shortcomings, I think letting private finance enter the capital market gradually, establishing laws to protect private finance, and regularizing and legalizing private finance is the best method to solve the problems mentioned above.

b. Legalize and regularize the private finance

According to theory of financial medium, any financial intermediary can be regarded as the united individual borrowers in the transaction to overcome transaction costs, diseconomies of scale. The transaction is the reason why financial intermediaries exist. For private financial institutions, as the scale of private financial organization enlarges, financial assets from members will increase sharply and the customer hierarchy will transfer. They are no longer the original financial weak groups. The nature of folk financial organizations must change. What's more, the information cost and management cost will continue to increase to the extent that private financial institutions have no advantages to modern mainstream financial institutions while the number of members grows sharply. Private finance marginal cost of loans decreased first and then increased, just like the shape of "U".

For modern mainstream financial institutions, they can play more reasonable roles which accumulate credit behavior between individual borrowers and lenders into many borrowers and lenders so that they can handle the

massive amount of information together. In this way, the cost of allowing temporary credit will decrease greatly. According to the foregoing, marginal cost of loans of modern mainstream financial institutions will decrease as the number of consumers increase, so the marginal cost of modern mainstream finance will incline downward gradually.

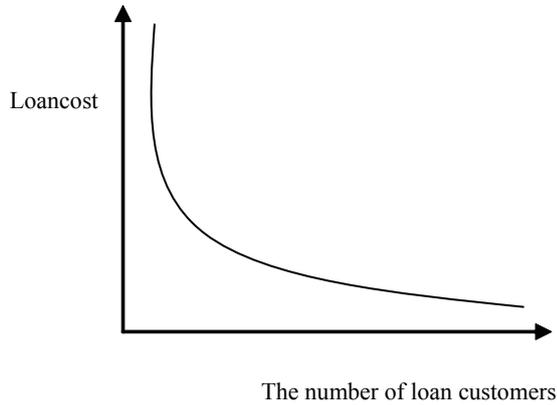


Figure 5
The marginal cost of modern mainstream finance

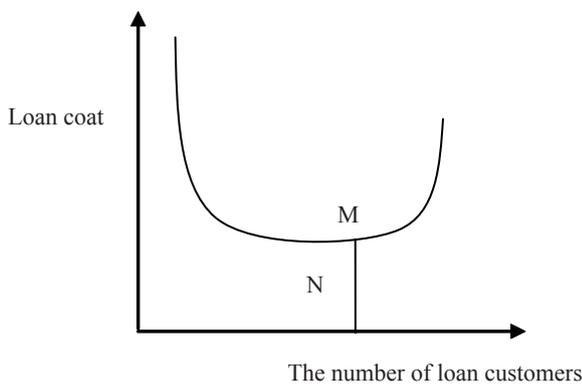


Figure 6
The Marginal Cost of Private Finance

On the basis of analysis above, private finance marginal cost of loans can be visually represented by a U-shaped curve. When the scale increase to a certain extent, marginal cost of loans will increase, but marginal cost of loans will decrease by professional work division after private financial institutions turn into modern mainstream financial institutions. So legalizing and regularizing private finance will not only get more legal protection and make it convenient to regulate, but will also reduce the marginal cost of loans and promote the development of private finance just like the Chinese saying: “shoot two hawks with one arrow”.

c. Government financial support to SMEs should pay attention to the combination of micro-profitability, safety, and liquidity.

Government financial support to SMEs is a major way to raise money for SMEs. Especially when an SME is in the initial stage, this support is very significant. Government has strengthened the support to SMEs

through some measures in recent years. These measures improved the SMEs’ difficulty in financing to some extent. However, it also has problems, such as the disunity of the management mechanism, excessive administrative intervention, poor management of mortgage, and the scale of the financial support system is too small. This article supports the idea that government financial support to SMEs should pay attention to the combination of micro-profitability, safety, and liquidity. That creates a support mode of commercial bank or a policy bank mode with profit-making capabilities. The government financial support can’t be sustained if there is no return, but unlike general commercial banks which aim for the maximization of profit, government financial support system should pay more attention to promote the development of SMEs and pursue a lower return than general commercial banks. Of course, safety and liquidity should also be considered as the target so that the support system can operate well.

2.1.3 Strengthen the Competitiveness of the Capital Market, Realize the Marketization of Interest Rates.

Nowadays, the financial structure in China is very unitary. Large, state-owned commercial banks monopolize the financial industry. SMEs can’t find suitable and guaranteed financial institutions to borrow money from except large state-owned commercial banks. If the government allows private finance enter the financial field, SMEs will have more choices when they need money. Additionally, large state-owned commercial banks will improve their service and management to adapt to the new environment after the competitive power enters the financial field and the overall service level of financial field will improved. Marketization can also be realized after the private capital enters the financial field and the large state-owned commercial banks stop profiting from the rate gap between savings and loans. As a result, the loan cost will decrease.

2.2 Internal Environment

From the perspective of external environment, both indirect financing and direct financing have many constraints. These constraints can’t be solved in a short time, so SMEs can also start from the inside, promoting the financing difficulties by improving the operation of them.

One of the major reasons for SMEs can hardly get loans from large state-owned commercial banks is the cost for collecting the information of SMEs, especially the financial information of enterprise. This financial information reveals the operation of enterprises and directly determines whether financial institutions can provide loans for enterprises. The financial system of many SMEs is not normal in China nowadays. Without a formal, accurate financial statement to reflect the business information of enterprises, information asymmetry between financial institutions and enterprises exists so that the financial institutions cannot loan to SMEs. So normalizing the financial system will reduce the

information asymmetry between financial institutions and enterprises, decreasing the cost for collecting the information of enterprises, then increasing the chances for enterprises to get loans from financial institutions.

CONCLUSION

SMEs have made great contributions to the development of Chinese economy. Although the financing difficulty of SMEs has been slightly eased since 2010, the improvement remained at quantity level. The government didn't solve the root of the problem.

The reasons for this problem are classified into external reasons and internal reasons. External reasons divided into direct financing difficulty and indirect financing difficulty. SMEs in China have no access to capital market for direct financing and because of high cost for collecting information of enterprises and low return compared to loan to large state-owned enterprises, state-owned commercial banks unwilling to loan to SMEs, and both sides restricting the financing of SMEs.

From the perspective of internal reasons, faultiness of SMEs' financial system caused information collection cost to be very high. Normalizing the financial system will reduce the information asymmetry between financial institutions and enterprises and decrease the information collection cost.

POLICY PROPOSALS

A. Improved Enterprise Listing System, Strengthen the Construction of the Second Board

Direct financing is the most convenient and direct way for SMEs to raise money from the capital market. Marketization degree in China is relative very low at the moment. The capital market is still in the initial stage. Deficiencies of the market system, especially deficiencies of the listing system, cause SMEs to be unable to access indirect financing. In response to these conditions, government should decrease the threshold of listed enterprises, enforce the construction of the second board, and try its best to create a good direct financing environment.

B. Allowing Private Capital to Enter the Finance Field, Legalize and Normalize the Private Finance

Private capital is the most dynamic capital. Because of financial repression in China for a long time, efficiency of financial resource allocation is very low. Although China does not allow private capital to enter the financial sector, there are still large numbers of backward financial institutions, like native banks, lending companies, and

pawn shops in China. So China has both backward private financial institutions coexisting with modern financial institutions. In response to this phenomenon, government should devote energy to legalizing and normalizing the private finance so that efficiency of financial resource allocation is improved. Meanwhile, only by protecting the private capital by laws can private capital become legalized, as the participation of private finance the capital market will be more competitive and the SMEs can have more choices and enjoy better service.

C. The Government Support System Should Pay Attention to the Combination of Micro-profitability, Safety, and Liquidity

Financial support by government is very important for SMEs, but we should consider the sustainable development of the support system. This article proposes combining micro-profitability, safety, and liquidity. Only with the inclusive finance philosophy can the support system become sustainable.

D. Normalize the SMEs' Accounting System

The irregularity of SMEs' accounting system caused the information asymmetry between financial institutions and enterprises. The cost of information collection of banks is too high. If we normalize the enterprises' accounting system, we can not only reduce the information asymmetry between financial institutions and enterprises but also decrease the information collection cost, while creating good internal financing conditions.

E. Strengthen the Supervision Mechanism and Improve the Incentive Mechanism

Supervising is a very important and indispensable link whether in the construction of capital market or allowing private capital enter into the financial field. When easing the constraint of listed companies we should also pay attention to supervision. Allowing private capital to enter into capital market will also cause some fluctuations in the market; without good supervision, confusion, as witnessed in some developing countries, will probably replay in China when they loosen the financial control. Accounting system of SMEs also needs supervision, so that we can avoid the manipulation of enterprises in order to obtain loans. As an important link in the supervision system, the independence of a regulator is very crucial; only through independent status can the supervision can be open, fair, and equal.

Incentive mechanism also plays an important role in each financing link for enterprises. Government should punish the enterprises that dare to manipulate accounts and cheat for getting into stock market. If the punishment measures are not tough enough, it will lead to enterprises risking cheating huge amounts of money and eventually getting less severe punishment.

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