Financing of Small Medium Enterprises in India: Issues and Challenges

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Abstract

The purpose of this paper is to develop the understanding of challenges faced by the Small Medium Enterprises for fulfilling their financial needs in India. Finance has been a matter of concern for all the stakeholders, despite the various efforts of Government. SMEs have very limited options for finances and face various challenges in arranging the same. The paper highlights the challenges for this sector which is the fastest growing industry as per the Ministry of Micro Small and Medium Enterprises. The existing body of academic literature pertinent to the domain is reviewed so as to develop the understanding of the challenges of Small Medium Enterprises in India. The results show that Small and Medium Enterprises do face a lot of challenges when accessing funds from the formal financial institutions in India. The study also find out that SME sector is considered as a risky industry there by credit facilities are offered at a high rate of interest as compared to other corporations. This paper is also an attempt to understand the financing challenges of SME's in India.

Keywords- Finance, India, SME's

SMALL MEDIUM ENTERPRISES IN INDIA: ISSUES AND CHALLENGES

Last 50 years have seen a huge growth in the Small and Medium Enterprises (SME) sector playing a vital role in the economic development of India. Being a low cost and high labor intensive sector it has emerged as large employment provider in the rural & backward areas as only 20% of MSMEs operate in areas other than rural areas (CII). SME sector in India contributes about 8 percent to Gross Domestic Product with an investment of less than 50 million. India is in transitory phase of growth and as forecasted by International Monetary Fund (IMF) that the growth rate in India will be 7.8% in the year 2018-19 (Department of Commerce, Govt. of India). The statistics of SMEs presents how the sector is and can contribute to Indian economy. Total 42.5 million registered and unregistered SME units are the backbone of our economy making 95% of industrial units in the country. The variety of products manufactured is more than 6000 and they employ 40% of the working population. SMEs contribute 40% of the total exports and 45% of Indian manufacturing output (msme.gov.in).

Due to its high share in the domestic production and exports it has helped in reducing regional imbalances and equable distribution of wealth. They are also complementary to large industries as most of the SMEs are the ancillary units which provide operational flexibility and mobility. The reforms in India complimented with the working age population promises strong economic and corporate growth. The working population in India also puts a challenge of unemployment if we fail to deliver the growth as expected.

The Government statistics shows the brighter side of SMEs in India but the 100^{th} ranks of India in World Bank's list of Ease of Doing Business show how we are lagging in fully utilizing the potential of the sector but also offers the opportunity. SME sector provides the solution to the problem of sustaining the growth. Less capital requirement and more employment generation by this sector ensures that India can achieve the desire level of growth with a proper combination of economic factors. Strengthening of this sector with proper reform, policies, infrastructure will help India to perform better than other developing economies. Government of India in MSMED Act in 2006 addressed the issues and challenges faced by this sector and the reforms to make this sector more competitive. Both service and manufacturing entities were included in the preview of SMEs.

Challenges of SME sector

The most important issues faced by SMEs is lack of capital, lack of skilled human resources, accounting, and administrative management and lack of vision. Most of the firms are started on the impulse without any in-depth- analysis of the market or competition, resulting in disillusion of turnover and in repayment capacity for bank loan (Paul Derreumaux, Chairman and CEO of Bank of Africa).

SME sector in India faces many challenges. When the Indian economy is promising for high growth rate, this sector needs to be strengthened. Keeping pace with the technological advancement, lack of skilled labor and infrastructure adds to the challenges along with maintaining the quality and the standards of the products. But above all the biggest challenge faced by this sector is the availability of finance even though when the sector is in the priority list of lending sector of Reserve Bank of India. Financial deficiencies might prevent them from growing to their optimal size. Both in the developing and developed countries it has been found that small firms have less access to external finance and are more constrained in operation and growth (Berger and Udell, 1998; Galindo and Schiantarelli, 2003). It is important to understand financial obstacles to SMEs' growth in India.

These Ist generation of entrepreneurs lack in experience. These are the small and new entrepreneurs who fail to bring in any initial capital or contribution in the business. Banks practices all over the world has provided bases for evaluating SMEs for the purpose of making funds accessible to them (Ohachosim, 2012). Due to the lack of experience they accounts are not properly maintained which further restraints the financial institutions in extending credit facilities. Due to the lack of proper accounting information it becomes difficult for the financial institutions to calculate the risk and access the profitability of the entrepreneurs. Good credit rating is pre condition for financing and pricing of loans. Majority of SMEs are non bankable or have no credit ratings (Yadav, R. J. 2014).

Despite the efforts of Government, and inclusion SMEs under priority sector, still the mismatch of demand-supply exists. Financial Institutions perceive credit risk in financing SMEs on account of non-availability of vouchers and lack of proper accounting systems.

To cover such credit risk, financial institutions look for collateral or traditional equity. The size of the firms also increases the transaction costs. Lack of collaterals is another issue with the SMEs. Cuevas et al. (1993) indicates that a major constraint to the growth of SMEs is due to the lack of access to bank loan by SMEs is their inability to pledge acceptable collateral. Collateral are an incentive to bank for repayment of loans and offset losses in case of default. Aryeetey et al. (1994) argued that banks can offer alternative to collateral such as guarantors, sales contract, liens on equipment financed. Due to the reluctance of financial institutions the transaction high cost is high.

Small businesses have very poor working capital management traditions. A study in Northern America, show that they have no formal techniques of determining the level of cash balances (Anvari and Gopal, 1983). This would mean that there are chances of SMEs keeping more cash than they actually required or otherwise. Grablowsky and Rowell (1980) in a survey found that small businesses have poor credit management. In India, SMEs need to manage inventory and accounts receivables to be more profitable. Most SMEs have lenient or less concerned for their working capital position, and many of them do not have standard credit policy as they focus on cash receipt and bank account position.

Schiffer and Weder (1991) argued that small firms tend to experience more difficulties than medium-sized firms and large firms.

Conclusion

The advancement in the technology is providing opportunity s particularly for B2B ecommerce firms focused on the Indian SME sector. Digital transformation and smart phones becoming more and more affordable, Indian SMEs are experiencing simultaneous adoption of web as well as mobile based technology. Small firms have very weak financial position and they rely on credit facility. Most SMEs become insolvent due to the lack of financial assistance from the financial institutions. The poor liquidity and working capital management in most SMEs leads to shortage of fund The poor book keeping and accounting system reduces the ability of the firm to maintain flow of their working capital which has affected their ability to compete effectively.

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