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# CHOICES OF SMES FOR RAISING FINANCE : A SYSTEMATIC REVIEW

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## ABSTRACT

The fact of financial assistance is becoming a matter of vital importance for the Small and Medium sector enterprises or the SMEs, for their development and their sustainable growth so that they become efficient throughout their part in the promotion of new enterprises, as well as support the inventive process and nurture the growth as well support the promotion of the existing as well as the present SMEs, which, provides a boost to the economic development. The primary objective of this study is to notify the difference between large firms and SMEs considering their behavioural and financial choices. Therefore, this paper attempts to provide a systematic review on the different sources of finance that the SME's take into account along with the characteristic variations of the SME's and also the variations in view of the ownership of the SME's.

**Keywords :** "Small and Medium Sector Enterprises (SMEs), Finance, Sources of finance, financial behaviour, growth of SMEs."

## 1. Introduction :

As per the growth in the finance paradigm, financial requirements along with the various financing alternatives that are available for the SMEs generally keeps on changing during the different stages of a firm's growth cycle, as stated by **Udell and Berger (1998**). In simple words, numerous financing tactics are needed during different phases of a firm's life cycle. Commonly, due to the distinct features that distinguish the SMEs with the Large firms, during their start-up period, like the – high chances of failure, absence of trading history and informational density, SMEs during this period depend heavily upon insider financing sources.

The most significant factor that has been underlined for the expansion, development, and well-being of the SMEs is the accessibility of finance. The SMEs begins to adjust its capital structure gradually during the advancement of their business cycle. This means that as the SMEs mature, during their successive growth period, they begin to initiate a statistical record according to their potentiality of providing collateral. This in turn helps to develop the trustworthiness of a firm.

Financing strategies employed by the SMEs differ from the primary internal sources, like the- venture capital, merchandise credit, and the angel investors, owner–manager's individual savings along with the retained profits to unofficial external sources, like, financial assistance and support by friends as well as family, and consequently to official external sources including, various financial institutions such as banks as well as the Nbfc's. Thenceforth, the firms initiate to substitute internal with the external funding sources, which incorporates business credit, bank loans, and stockholders, to mention a few.

Studies by **Kimhi (1997), Barton and Gordon (1987),** acknowledge the financial performance of the SMEs by using the" lifecycle model". According, **La Rocca et al. (2011)** figured out, "to a great extent, the financial performance of the SMEs possibly can be accredited to the pattern of the lifecycle, which was found to be uniform and coherent with time and also fairly similar across various industries and systematic

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contexts."

Nonetheless, many other studies criticize this business lifecycle model affirming the fact that it fails to provide a detailed picture of the financial decisions undertaken by SMEs. For instance, the financing pattern of the SMEs as complements with the "pecking order model" as elucidated by **Udell and Berger (1998).** This model formulated by **Myers (1984)** advocates that "the decisions related to the capital management of an organization are of great concern to determine the firm's age." Theoretically, local resources used in financing get registered, and foreign resources remain obstructed until the local sources get depleted. As a consequence, while looking for funds, a firm chooses short-term indebtedness over long-term indebtedness, external indebtedness over external equity, and internal equity over external indebtedness. Hence, by preference, the sources of finance of a firm should supervene the qualities of issuing debt, issuing equity, and then internal equity. As per the " pecking order model" and regardless of the "lifecycle theory," **Gregory et al. (2005)**proclaim, "outmoded SMEs ought to be quite less adaptable on the foreign sources of financing rather than the newer SMEs." This ascribes the matter that since the outmoded SMEs have sustainable chances of making cumulative profits apart from the newer firms, the number of local funds available in the outmoded firms are much more, which they use for financing their operations. The lifecycle model as conceded by **Berger and Udell (1998)** doesn't seem applicable for all the SMEs functioning in various industries suggesting that information accessibility, firm size, and age -which are preconceived to comprise the foundation for this specific model- are not properly related. The financing of the SMEs can never be regulated as acknowledged by **Gardine (2005).** Moreover, as per the results and inconsistency within the lifecycle model, the financial alternatives, as well as the financial needs of the SMEs, depends on the factors like age/size/ information, except the size of the firm was discovered as a considerable predictor (only in some cases) for taking the decisions related to the financial structure of the SMEs. A work by **Martín-Ugedo (2005)** and Sanchez-Vidal based upon the Spanish SMEs even approves the "pecking order model. " As per the factual results, the patterns of financing which are pursued by the firms did not complement with the pattern that is advocated by the asymmetric "pecking order model." Furthermore, they also found something reverses to what the model suggests, that is, no sign of interrelation between the deficits within the domestic sources to the increasing of finance. Increasingly, while the pecking order theory prognosticates that the issuance of shares should be circumvented by the firms with considerable information, but the unevenness in their results proves that irregular information variables lack the potential to influence the decisions.

Regardless of the attempts that are made to hypothesize the financial strategies which are undertaken by the SMEs, resulting in various patterns of financing; "suggests that different theories involve different approaches." Although, widespread acceptance of the characteristic influence of the SMEs and entrepreneurs for choosing methods of financing. The influence as well as the features is concisely discussed before providing a systematic review of the financing sources of the SMEs.

## 2. Literature Review

### 2.1 SMEs and their contribution to the economy

SMEs, are likely to play various roles in the economy due to the easy availability of resources and information. Most of the SMEs are convoluted in industry, commerce food, and lodging, construction, and services. Simplified strategies are significantly important for the development of the operating SMEs. Various research suggests SMEs with diverse strategies face a lot of hardships to innovation. These obstacles play a significant role, to achieve growth in high priority regions, like knowledge-intensive organizations. A survey conducted by **Wynn and Okpara (2007)** about the SME failure in Nigeria reveals the fact that weak location prompts to obscure businesses for both the suppliers as well as the customers.

The SMEs which are located outside the prime cities have to encounter considerable difficulties in procuring external finance, basically long-term liabilities, in contrast to their correspondents functioning in different other cities. Consistently, **Asah and Fatoki (2011)** conclude, "Physiographical location of the SMEs situated near to the banks has a greater advantage to develop a cemented relationship to get funded by those banks." As a consequence, SMEs can avail bank loans easily using nothing but partial qualitative information.

**2.2 The size of the firm and the acceptance of bank loans**

Despite the absence of any agreement amongst the researchers regarding the principle that must be followed to estimate the firm's size, the conception of the firm's size is inversely proportional to the activities and capacity of the SMEs. The size of the firm is usually combined apparently to its age as it may have some related influence on the life span of the firm. Thus, observed in decision-making procedures relevant to capital acquisition and finance, that is, either one specific kind or another should be preferred and employed. **Cassar (2004)** after studying the firm's financial structure by utilizing a specimen of around 292 firms, inferred that" larger l small firms depend more on external financing and long-term liabilities, which includes bank loans." **Storey (1994)** found something similar to this, that is, for the SMEs, " the individual savings of the owner and the manager is more essential because it might serve as a source of capital during the start-up phase than the external sources of finance like overdrafts and loans from the banks. " Differently, **Petersen and Rajan(1994)** measured that the firm's size can be influenced by the accessibility of finance in the firms. They proclaimed that as the firms progress in their capacity to extend the sphere of banks from which they can borrow.

Besides this, it also has a considerable influence on the utilization of bootstrapping to increase the business. **Neeley and Van Auken (1996)** enunciates that: " Owners of the non-manufacturing or sole proprietorship firms should always be prepared to initiate a financial plan that includes the use of more financing alternatives like, hire-purchasing, factoring, leasing and trade credit, than the owners of the sole proprietorship or non-manufacturing firms.". According to the financier's viewpoint, the relevant points of debt financing for SMEs are financial institutions or banks, which accompanies widening the problem of information analysis as negligence in imparting to the SMEs so that the substantial utilization of securities is justified and comprehensible accordingly. As the factors like the dearth of segregation of the director as well as the firm govern the firm's financing preferences. Concerning the legal form, **Cassar (2004)** comes up with the observation, that integration can be noticed from the banks and other finance organizers, which acts as a sign of encouragement for the creditability of the firm. Subsequently, established firms seem to exist in an extremely preferred place while receiving external finance in contrast to unorganized SMEs. The various analysis concludes the fact that a minimal number of private companies depend upon bank financing.

**2.3 Sources of grants for the SMEs**

The increasing concern of the SMEs is to get access to capital. While SMEs focus commonly on bank module of financing it's also necessary to understand the various structures of the market, which conveniently more preferred regarding lending to SMEs. Various analytical studies or theoretical evidence contributes to a significant amount of knowledge regarding the bond among the financial institutions and their management, etc. **Udell, (2004)**, tried to identify more comparison among relationship lending and lending technologies to acquire a detailed knowledge of the different financial technologies, thereby concentrating on the corresponding benefits of various types of financial institutions for making transactions using the latest financial technologies.

Intending to this, briefly, we can conclude that making transactions using financial technologies is mainly focussed on "hard vicenary information" which can be noticed and confirmed during finance appraisal.

Nevertheless, the financing methods, focussed mainly on the information derived from various sources though they are diverse but have an intricate relationship with the owner of the SMEs, and the core personals of the company.

**2.4 Role of banks and financial institutions in lending funds to SMEs**

With a focus on empirical studies, **Naaborg, Udell, (2004 ) de Haas and Berger (2005),** stated that "foreign-owned institutions comparatively may have better benefits in the SME technologies and the localowned institutions may have better benefits in developing relationship."

This presumption can be understood by the following causes. Few plannings have been indicated to pacify credit rationing, like, an efficient legal framework, a loan agreement system, and alternative financing sources.

Firstly, Foreign banks had often faced with problems in transmitting and processing small information over longer distances, using more administrative layers. The existence of asymmetric information and other basic problems may prompt the sellers of the financial services to deliver products which, due to lack of monitoring, had left the capable borrowers without getting access to finance. This has emphasized lenders to gain creditworthiness and reputation and has helped to distinguish between good and bad borrowers.

In addition to this, they are compelled to negotiate with multiple cultural, economic, language, and administrative environments that influence the lending facets. Local banks prefer financing SMEs as they deal perfectly with anything related to relationship lending. Relationship lending is a form of financing, where information is gathered by bank officials maintaining a personalized approach to SMEs and their owners. This helps in reducing the uneasiness and mitigates the chances of opportunism connected with the bank and is financing the SMEs.

Some recent studies by **Beck, Martinez, Demirgüç-Kunt (2010)**, deals about the supply side analysing the cross-country information, rather than demand-supply position. The significant variations about the type of ownership in financing technologies and firm structures are: Foreign banks prefer hard information corresponding to private ones. In external banks, the stake of guaranteed SME loans is more guaranteed, rather than the internal banks.

Despite these approaches, the outcome shows that different techniques of financing and firm structures provide similar results related to SME funding. Consequently, different banks, implement various financial tools and firm structures. Therefore, the credit guarantee program balances the reduced responsibility of the non- reviewed financial statements this conceivably improves financial access and loan and credit terms. Governments initiate to spend in loan guarantee programs, as they address the imperfections in the market that results in credit restrictions for the SMEs, and they induce innovation within the SME sector. In short, SMEs prefer to work with smaller banks, which pay more attention to meet their requirements.

**Conclusion**

The paper offers an analysis of the different financing sources, available for SMEs and also includes the other characteristics of this sector. Initially, the presence of various types of financial institutions in the market and the competitiveness among them can result in a significant impact on credit availability for SMEs because different institutions have different financing technologies. Secondly, the existence of external and internal financial institutions, as well as the presence of non-manufacturing and the sole proprietorship measures the concentration that may influence the credit availability for SMEs.

Specifically, a considerable presence of external financing sources and the minor presence of the internal financing sources are associated with higher SME credit accessibility because the foreign institutions appear to receive more benefits in their financial technologies, but the local institutions seem to be disadvantaged commonly. Thirdly, the increasing significance of the economic grants helps us to understand the behaviour, financial stability, and decision-making capability of SMEs. Hence, the outcome of the research emphatically advocates that "better financing infrastructures can make considerable differences in the SMEs credit availability, thereby facilitating various financing technologies."Finally, we can consider the financial behaviour of large firms is not similar to SMEs. Likewise, small private banks can generate a large base for gathering the financing requirements for the SMEs.

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