

Small and Medium Enterprises (SMEs) in obtaining credit in India: Financial Analysis

*Dr.Y.V.Rao, ** Abdul Basheer Ahamed Beg

*Professor, Dept. of Management studies, Vignan's University, Vadlamudi, Guntur, Andhra Pradesh, India

**Research Scholar, Dept. of Management studies, Vignan's University, Vadlamudi, Guntur, Andhra Pradesh, India

Abstract

The Challenges faced by Small and Medium Enterprises in Obtaining Credit in Andhra Pradesh., was undertaken to highlight the issues facing SMEs in Andhra Pradesh. in their quest to accessing bank credit (loans) from financial institutions (banks & non-banks) to undertake various activities; be it general business operations or carrying out expansion project all in the name of fulfilling the objectives as being job creators and helping to reduce poverty.

In tackling this topic, the quantitative approach was adopted. Questionnaires were circulated to 1200 SMEs in 4 selected districts, Guntur, Prakasam, Krishna and Visakhapatnam in Andhra Pradesh., through a technique of convenience sampling. Based on the responses received through these questionnaires, the following major findings came to the fore.

There are institutions such as bank and non-bank financial institutions that are willing to provide funds to SMEs but Andhra Pradesh SMEs are not able to meet the requirements of these financial institutions. Chief among these requirements is the issue of collateral, which most SMEs cannot provide. Aside this is the other issue of small equity base of these SMEs among others.

Secondly, those who are able to access this credit are also faced with high interest rates and short repayment periods making it very difficult to embark on any developmental or expansion projects. Another interesting revelation with regards to the high rate of defaults in repayment of loans contracted, relates to the tight Cash flow situations of these SMEs that is mostly due to difficulties in the management of the account receivables of the respective SMEs surveyed.

The study concludes with some recommendations to help free up capital or credit to the SME sector. Among the recommendations are encouraging financial institutions (banks & non-banks) to establish factoring services, enforcement of the credit reporting act and finally provision of tax incentives for banks that lend to SMEs to encourage others to do same.

Key words: SME financing, financial analysis, Credit standards, Govt. Schemes, Factoring services

I. INTRODUCTION

There is growing recognition of the important role small and medium enterprises (SMEs) play in economic development. The SMEs constitute about 90% of total business units in Andhra Pradesh, and account of 60% of employed labour force.

Economic development is a process of economic transition involving the structural transformation of an economy through industrialization, rising GNP, and income per head. Economic growth on the other hand, contributes to the prosperity of the economy and is desirable because it enables the economy to consume and contribute to more goods and services by increasing investment, increase in labour force, efficient use of inputs to expand output, and technological progressiveness. Any nation that experiences economic development and growth will benefit from improvement in the living standards especially if the Government can assist in growth by implementing complementary and growth-enhancing monetary and fiscal policies.

II. OBJECTIVES

To highlight the specific challenges inhibiting SMEs in accessing credit in Andhra Pradesh, with a view to proposing some recommendation to help mitigate these challenges.

In pursuance of this objective, the following research questions were administered:

- Does SMEs have challenges in accessing credit in Andhra Pradesh? What are they?
- To what extent has these challenges affected their operations?
- What alternative sources of funding are SMEs resorting to and how viable are these?

III. STATEMENT OF THE PROBLEM

1. Despite the role of SMEs in the Indian economy, the financial constraints they face in their operations are daunting and this has had a negative impact on their development and also limited their potential to drive the national economy as expected. This is worrying for a developing economy without the requisite infrastructure and technology to attract big businesses in large numbers.

2. Most SMEs in the country lack the capacity in terms of qualified personnel to manage their activities. As a result, they are unable to publish the same quality of financial information as those big firms and as such are not able to provide audited financial statement, which is one of the essential requirements in accessing credit from the financial institution.

3. Another issue has to do with the inadequate capital base of most SMEs in the country to meet the collateral requirement by the banks before credit is given out.

4. These are some of the factors already acknowledged by some researchers as blocking most SMEs in accessing credit from the financial institution in the country. But are these really the case in Andhra Pradesh in India.

IV. RESEARCH METHOD

To achieve the proposed research objective of highlighting the specific challenges inhibiting SMEs in accessing loans /funding in Andhra Pradesh., the quantitative research method was adopted, which often is the most efficient and cost- effective research method.

V. DATA COLLECTION TECHNIQUES

The data for this study were gathered through the use of primary and secondary data sources. The primary data source for this study involved the use of questionnaire. The questionnaires were distributed to SME operators and/or owners for first-hand information for processing towards answering the research questions.

VI. SAMPLE SIZE

Following definition of SMEs that classified SMEs into:

- Small enterprise – (800 workers)
- Medium enterprise – (400 workers)

A sample size of the 1200 SMEs was targeted for responses. Questionnaires were distributed to these SMEs out of which we received responses from 1000 SMEs. This represented about 83% of the response rate which we deemed to be impressive for this study.

VII. SAMPLING TECHNIQUE

The method of convenience sampling was employed in arriving at the 1200 SMEs, which the researchers believe possesses the experience relevant for this study and who have sufficient time and were willing to participate. This technique, convenience sampling, involves obtaining responses within the

sample frame from willing respondents and also their availability for the study.

VIII. RESULTS AND ANALYSIS

A descriptive statistics was found to be an ideal analysis technique and subsequently used in ascertaining the difficulties that SMEs faced in accessing bank loans. Aided by the tabulation of data extracted from a close-ended questions surveyed, it was easier to understand the issues identified by the respondents.

Also to help answer the question whether or not SMEs have challenges in accessing credit in Andhra Pradesh as contained in the objectives in chapter one, the below hypothesis were formulated and tested using test of proportion:

H1: More than 50% of SMEs face challenges accessing credit

H0: Not more than 50% of SMEs face challenges when accessing credit

These could also be expressed statistically to be:

H1: $P > 0.5$

H0: $P = 0.5$

Where P = the proportion of respondents who face major challenges in accessing credit in Andhra Pradesh.

n = sample size, hence $n=68$ and X being the number of respondents facing difficulty in accessing credit

Level of significance:

Let $\alpha = 0.05$

Test Statistics:

$$Z = \frac{X - np}{\sqrt{npq}}$$

Where z follows the standard normal distribution $N(0, 1)$

Null distribution:

X follows $B(68, 1/2)$ and since $np = n(1-p) = 68 \times 0.5 > 5$, we can approximate the binomial to the normal distribution

Decision Rule:

If the computed p value is less than the level of the significance $\alpha = 0.05$ we reject H_0 otherwise we fail to reject H_0

i.e $p^* = P(X \geq x / H_0)$

Computation

Given that $n = 68$, $x = 50$ and $p = 0.5$

Our P value can be calculated as:

$$P^* = P(X \geq 50)$$

By approximating the binomial to the normal distribution, we had

$$P^* = P(Z \geq \frac{50 - 68 \cdot 0.5}{\sqrt{68 \cdot 0.5 \cdot 0.5}})$$

($n = 50$ has been reduce to 49.5 due to continuity correction)

This implies,

$$P^* = P(Z \geq 3.759) = 1 - P(Z \leq 3.759)$$

$$= 1 - 0.9999 \text{ (read from the Standard Normal Table)}$$

$$= 0.00$$

Decision: Since the P value ($p^* = 0.00$) < the level of significance, we reject H_0

Result: The small P^* value of 0.00 which is far less than the level of significance gives us enough evidence to conclude that more than 50% of SMEs face challenges accessing credit.

IX. PRESENTATION, ANALYSIS AND DISCUSSION OF DATA

The data collection for this study was done basically through the usage of questionnaire. We targeted a population of 1200 SMEs and distributed the questionnaires among them. Out of the 1200SMEs to whom questionnaires circulated, 1025 SMEs were returned representing about 85% of response rate, which we deemed impressive considering the short time given to these respondents.

X. CHARACTERISTICS OF SMES

All the respondents are SMEs located in the selected districts of Andhra Pradesh., have a working force of between 8 and 53 employees with professionals in some managerial positions of the business. Out of the 68 respondents, 57% have had their businesses registered as Limited Liability Companies. The rest are registered as Sole proprietorships, Partnerships and Family owned as shown in table (7.1).

Table.7.1. Frequency Distribution of Forms of Participant SMEs

Form	Frequency	Percentages (%)	Cumulative (%)
Private Ltd Company	39	57	57
Public Ltd Company	0	0	57
Partnership	6	9	66
Sole Proprietorship	18	26	93
Family Owned Business	5	7	100
Others	0	0	100

Source: data compiled from field level survey

As can be seen from table 7.1, the bulk of the respondents SMEs are registered as Private Limited Liability Companies. They accounted for 39 out of 68 respondents, representing 57%. None of the respondents were Public Limited Liability Company. 18 respondents, representing 26% were Sole Proprietorship with 6 being Partnership. The

remaining 8% of the respondents SMEs were registered as family owned businesses.

These SMEs surveyed cut across the various sector of the Andhra Pradesh economy and also have an average monthly turnover ranging between as low as to a maximum as shown from table (7.2) and (7.3) below.

Table.7.2. Frequency distribution of nature/kind of participant SMEs.

Nature	Frequency	Percentages (%)	Cumulative (%)
Retail Trading	32	47	47
Export	15	22	69
Manufacturing	8	12	81
Services	10	15	96
Real Estate industries	3	4	100
Farming		0	100
Others		0	100

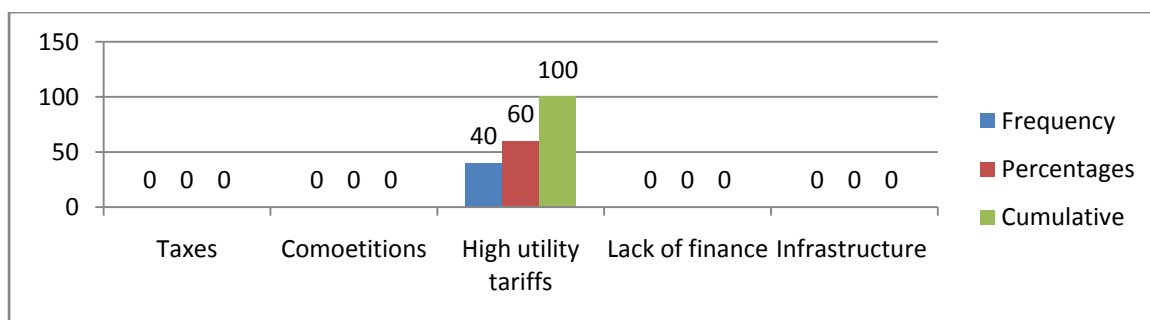
Source: data compiled from field level survey

It is a general knowledge that SMEs cut across the various sector of an economy, hence the 68% responses received were fairly spread across a wide range of the Andhra Pradesh economy with the most concentration centered in the retail trading sector. This sector alone accounted for 47% of the total responses as can be seen from table II. The export sector accounted for 15, representing 22%, Services, 10 or 15%, Manufacturing 8 or 12% and the Real Estate industries accounting for 3 or 4%. For all intent and purposes, apart from the Agricultural sector, all the key sectors of the economy were captured in the sample.

XI. SMES CONSTRAINTS

SMEs known all over the world are faced with lots of challenges in their operations and this was not

different from the responses received from our target respondents. SMEs operators who took part in the study were however asked to rank the major constraint they face in operating and growing their businesses. Lack/inadequate access to finance (bank loans) were considered to be a major constraint as it recorded 75%. This means that among all the problems faced by SMEs in their operation ranging from competition, high utility tariffs, infrastructure among others, the participant SMEs saw the lack of credit facilities as the major constraint. This assertion was also confirmed from the test run in the data analysis subsection in chapter three, where P value ($p^* = 0.00$) < the level of significance, which is $\alpha = 0.05$. Table (IV) below shows the various challenges faced by SMEs in Andhra Pradesh.

Fig.7.1. Major Constraint to the growth of SME

Source: data compiled from field level survey

A. Interpretation

The above shows participants rankings of the major problems facing the growth of their businesses in order on importance. 50 or 74% of the participant ranked lack of finance as the major constraints to the growth of their business followed by high utility tariffs, which recorded 15%. Competition and infrastructure were ranked as the 3rd major

constraint to the growth of SMEs with just 3% thinking that taxes also constrained their growth.

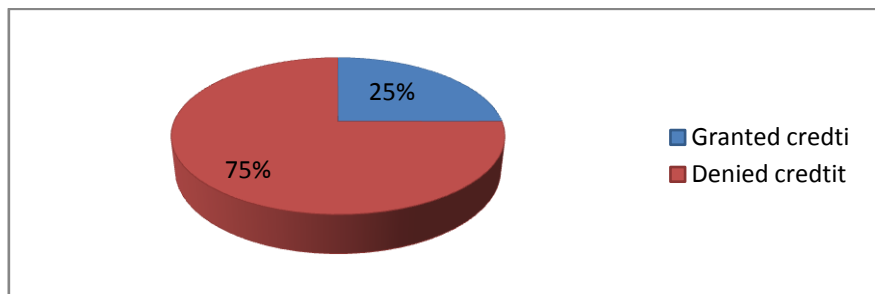
Factors contributing to SMEs constraints

The inability of SMEs in Andhra Pradesh to readily have access to credit from the country's financial institutions (banks) can be attributed to a lot of factors. The factors to the perceived high risk

nature of these SMEs small portfolios of these businesses and the high transaction cost that banks go through in performing credit appraisal on them before granting credit to these SMEs. In finding out factors contributing to the challenges in financing

SMEs attributed some of the causes to the type of lending infrastructure of nations. For them, it affects the feasibility and profitability of using the different lending technologies in SME financing.

Fig. 7. 2. Total number of participant SMEs granted or denied access to credit



Source: data compiled from field level survey

B. Interpretation

The above pie chart shows a number of participant SMEs who in one way or the other has been granted or denied access to credit from financial institutions. From the chart above, 75% of the total respondents say they have been denied access to credit, whilst 25% of them responded No to the same question.

Out of the 68 respondents sampled, 60% of them attributed their lack of access to bank loans or credit to their inability to provide the required security or collateral for the loans or credit being requested for and in situations where they are able to provide, it ends up to be inadequate, which accentuate the opinion of Banks.

Table.7.3. Frequency distribution of factors that hinders participants SMEs access to credit

Factors	Frequency	Percentages(%)	Ranking
Default on Previous Loan	2	3	5
No Security/ collateral	41	60	1
Small Equity base	15	22	2
Lack of experience Management	7	10	3
Others	3	4	4

Source: data compiled from field level survey

C. Interpretation

60% representing 41 of the total respondents of 68 ranked lack of collateral as the major factor preventing them from accessing loans from the financial institutions. 15 or 22% ranked small equity base as factor affecting their access to credit. Lack of

experience management was the opinion of 7 or 10% of the respondents with 4% thinking that other factors such as the inability to provide audited financial statement are preventing them from accessing credit with 3% relating their inability to access credit to default on previous loan.

Table.7.4 Frequency distribution of the level of interest rates on loans

Measure	Frequency	Percentages (%)	Cumulative (%)
Extremely High	48	71	71
High	18	26	97
Acceptable	2	3	100
Low	0	0	100

Source: data compiled from field level survey

D. Interpretation

The above table shows the opinion of respondents on the level of interest rates charges on loans from the bank and non-bank financial institutions. 48 out of the 68 responses received from participants saw the interest rates on loans to be extremely high. This represented 71% of the total responses. 18 or 26% of the total respondent think the rates are high with just 3% saying the rates are manageable.

One significant thing is that among the respondents, none saw the interest rates charged on loans by the financial institutions to be low. The extremely high interest rate group numbering about 48 out of the total respondents of 68 pays interest between 31% and 40% per annum. 26% of the respondents, which indicated that the rates charged by the financial

institution are high, also pay interest of 21% to 30% per annum, with just 3%, which we will term the “fortunate” ones servicing their loans at an interest of less than 20% per annum. This makes their businesses unprofitable as the profits made are eroded by the huge finance cost.

E. Alternative sources of SMEs financing

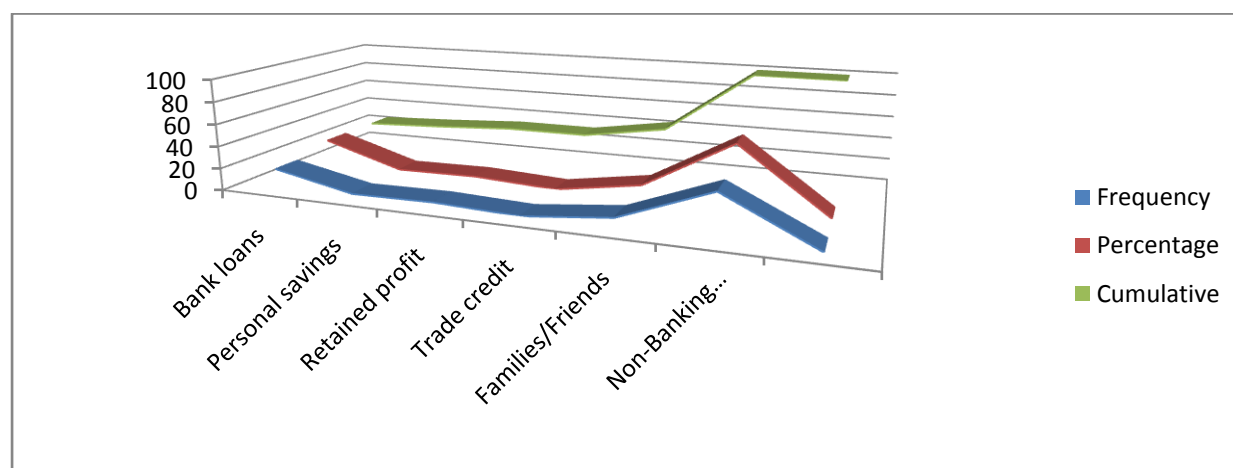
Since finance is the major constraints to SMEs development and growth, various sources ought to be explored by these SMEs to run their businesses. It came to the fore through the survey that most of these SMEs depend on mostly on external sources such as the banks, non-bank financial institution, families and friends and also personal savings the only internal source as alternative source of financing for their businesses. Table (7.5), below shows these sources.

Table:7.5. Distribution of SMEs major sources of funding

Source	Frequency	Percentages (%)	Cumulative (%)
Bank loans	17	25	25
Personal Savings	2	3	28
Retained Profit	3	4	32
Trade Credit	0	0	32
Families/ Friends	8	12	44
Non-Bank financial Institution	38	56	100
Others		0	100

Source: data compiled from field level survey

Figure: 7.3 distributions of SMEs major sources of funding



Source: data compiled from field level survey

F. Interpretation

Among the various sources in Table 7.5, which is also presented in the graph, 56% out of the total respondents ranked their major sources of funding from the Non-Bank Financial Institutions followed by 25% getting their financing from bank loans. The

third ranked sources of funding for SMEs operation are from families and friend with 12% and the fourth being retained profit with 3%. Personal savings was ranked the fifth with trade credit not resorted to as a source.

Table.7.6. Frequency distribution of sources of funds for start-up business

Sources	Frequency	Percentages (%)	Cumulative (%)
Personal savings	25	37	37
Bank Credit	8	12	49
Friends and Relatives	31	46	94
Others	4	6	100

Source: data compiled from field survey

G. Interpretation

The above table shows the distribution of SMEs sources of funding in establishing their businesses. It is clear from the table that 37% and 46% of the funds are generated from personal savings and relatives and friend respectively with 12% of SMEs start-ups getting their finances from the banks.

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