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## Financing situation and countermeasure research of Chinese small and micro enterprises under incomplete information

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### ABSTRACT

Compared with those large and medium-sized enterprises, small and micro enterprises (SMEs) in China face conspicuous financing disadvantages at present. The financial institutions are more apt to finance large and medium-sized enterprises, but strict with the small and micro ones. Therefore, most of them have no choice but to apply to internal financing. However, the small and micro enterprises make increasingly less profits and their internal financing ability gets increasingly weaker with the process of financial crisis. They are now struggling in severe financing troubles. The research, from the view of incomplete information, focuses on the financing sources, channels, and proportion of small and micro enterprises. Thus, it concludes that the main financing problems among those enterprises are insufficient knowledge of financing policies, the information asymmetry with financial institutions, and the information asymmetry within enterprises. Aimed at these problems, the research puts forward some corresponding solutions as follows. First, relationship lending should be developed. It sets its goal at the information asymmetry between small and micro enterprises and financial institutions. Second, credit information management should be strengthened upon small and medium-sized enterprises. This is intended for the information asymmetry between SMEs and the government and financial institutions. Third, managers of small and micro enterprises should know more about the enterprises. This is designed for the information asymmetry within enterprises and that between them and the government.

### KEYWORDS

Credit of small and micro enterprises; Incomplete information; Solutions; Relationship lending.



## INTRODUCTION

Since the international financial crisis in 2008, all industries in China have been affected at different level, the inflation gets increasingly serious, and the RMB obtains more and more appreciation under the international pressure. That leads to the decreasing profits of many SMEs in China's southeast coastal areas and the possible collapse of them. Hence, so many "runaway bosses" in Jiangsu and Zhejiang, since 2011, have made their appearances on media frequently, especially in March, 2013<sup>[1]</sup>. Ever since the reform and opening up, small and micro enterprises have been playing an irreplaceable role in absorbing labor force and the state economic system reform. According to the statistics from the State Statistical Bureau and the National Development and Reform Commission<sup>[2]</sup>, small enterprises registered in the Industrial and Commercial Administrative Department have accounted for 99% of China's total enterprises. The value created by them is around 60% of GDP. However, many domestic and foreign scholars think that due to the information asymmetry between internal factors and credit market<sup>[3]</sup>, most banks prefer to lend to the large enterprises rather than SMEs. Moreover, Chinese scholar Yifu LIN<sup>[4]</sup> also points out reasons why small and micro enterprises have such financing problems. Due to the unsound financial system and the transformation period from planned economy to market economy, many state-owned financial institutions are more likely to lend to large state-owned enterprises.

The research is designed to analysis the financial problems small and micro enterprises are facing with due to incomplete information, and the reasons leading to the problems. Furthermore, solutions are also given in the essay.

## FINANCING SITUATIONS OF SMALL AND MICRO ENTERPRISES AND ITS REASONS

### Definition of Chinese small and micro enterprises

Diverse countries have quite different definitions towards small and micro enterprises. With the development and transformation of national economy, China has made several alterations on the definitions of small and micro enterprises. The latest definition derives from *Type Standards of Small and Medium-sized Enterprises*, a document made by Ministry of and Industry and Information Technology in collaboration with three other ministries on June 18, 2011. Its provisions are shown in TABLE 1.

**TABLE 1 : The current judging standards on small and micro enterprises in some industries (unit: person, ten thousand Yuan)**

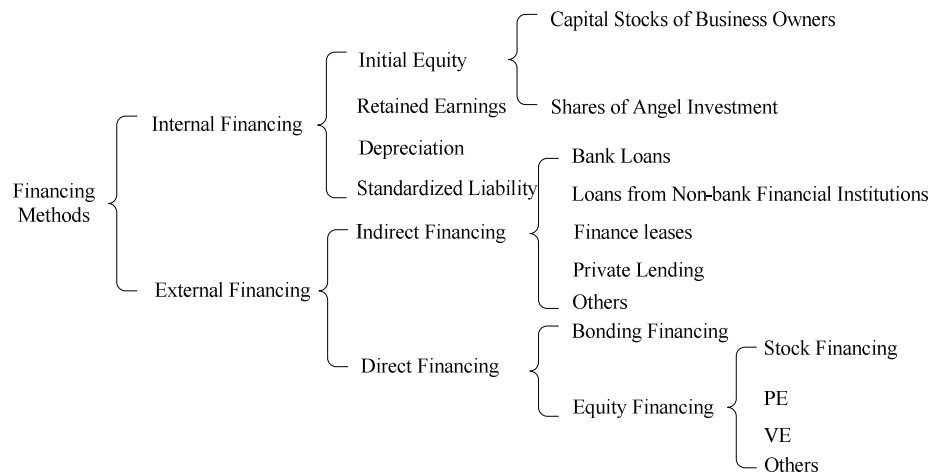
Sub-sectors	Micro Enterprises		Small Enterprises	
	Revenue (10,000 Yuan)	Number of Employees (person)	Revenue (10,000 Yuan)	Number of Employees (person)
Agriculture, Forestry, Animal Husbandry and Fishing	0-50		50-100	
Industry	0-300	0-20	300-2000	20-300
Wholesale Industry	0-1000	0-5	1000-5000	5-20
Retail	0-100	0-10	100-500	10-50
Transportation	0-200	0-20	200-3000	20-300
Storage	0-100	0-20	100-1000	20-100
Postal Services	0-100	0-20	100-2000	20-300
Accommodation	0-100	0-10	100-2000	10-100
Catering Industry	0-100	0-10	100-2000	10-100
Information Transmission Industry	0-100	0-10	100-1000	10-100
Software and Information Technology Service	0-50	0-10	50-1000	10-100
Property Management	0-500	0-100	500-1000	100-300

### Financing situations and problems of small and micro enterprises

Chinese small and micro enterprises mainly apply to internal and external financing channels, in which the external financing can be divided into direct and indirect one, just as shown in Figure 1. Chinese small and micro enterprises mainly employ internal financing. Statistics from *The Research Report of Operation and Financing Predicament of Small Enterprises*, jointly issued by National School of Development in Peking University along with Alibaba Group in 2012, have shown that the small and micro enterprises in China rely mainly on international money raising and external borrowing<sup>[5]</sup>. The research data from this report have come to a conclusion that the main sources of capital that funds SMEs, which can be seen in TABLE 2.

**TABLE 2 : Main capital sources of Chinese small and micro enterprises**

Approaches	Owners	Retained Earnings	Informal Stock Rights	Commercial Bank Loans	Credit Cooperative Loans	Informal Loans	Commercial Credit	Listed Stocks	Others
Percentage	36.7%	21.3%	2.3%	13.5%	6.8%	6.2%	12.4%	0.8%	0.0%
<b>Classification in Line with the Number of Employees of Enterprises</b>									
Less Than 50 Employees	42.3%	13.9%	6.2%	5.4%	8.3%	8.5%	15.4%	0.0%	0.0%
51 to 100 Employees	32.2%	11.8%	4.4%	20.6%	7.0%	4.8%	18.6%	0.7%	0.0%
101 to 500 Employees	27.7%	10.3%	0.8%	22.6%	6.6%	2.7%	27.8%	0.9%	0.6%
More Than 500 Employees	19.3%	15.2%	0.4%	47.1%	2.0%	0.0%	13.5%	1.4%	1.1%



**Figure 1 : Classifications of financing methods used by small and micro enterprises**

From TABLE 2, we can find that the financing of small and micro enterprises is mainly internal financing. In the process of financing, small and micro enterprises usually treat banks as their first choice and then turn to financial institutions for help. Besides, the methods in connection with informal stock equity and seeking financing by listing on market are totally ignored.

According to the above situation, the fact that small and medium enterprises excessively rely on internal financing in raising money can be observed. Nearly 60% of the enterprise funds come from internal financing, as concluded from TABLE 2. Also, there was a negative correlation between the employee numbers and the percentage of internal financing, that is to say the smaller the size of enterprise, the higher the dependency on internal financing. However, because of the economic crisis in 2008, SME's profit margin shrink in various degrees and its capacity for providing fund internally is decreasing. So, the MSEs will be stuck in financing troubles if they excessively rely on internal financing.

Still, new investment models such as venture capital have little effect because they are not popular. TABLE 2 shows that venture capital only accounts for 2.3% of the total amount of SME money raising. The statistics of database shows venture capital and angel fund investment also decreases recently. Compared with 2011, Private equity in 2012 decreased by 34.9 percent<sup>[6]</sup>.

**Causes of financing problem in SMEs at present**

Why do SMEs perform badly in money raising? Most scholars believe that it is because the economic development in China relies primarily on investments and exports, and domestic demand makes a low contribution to the economic development. But, affected by the economic crisis, China relies more on domestic demand in economic restructuring and upgrading. As a result of it, small and medium-sized enterprises growth is prohibited by many large enterprises. In addition, with the progress of our society, the labor costs are rising and profits are falling. SMEs can't conduct its business under this circumstance, let alone expanding operations. As a result of it, SMEs performed badly in money raising.

But all the generally accepted causes are not analyzed from perspective of incomplete information, so this study finds the following causes from this perspective:

### **SMEs not understanding the relevant laws and regulations**

Many surveys show that SMEs are not familiar with government's policies and regulations of financing. In 2012, Shanghai federation of industry and commerce made a research in SMEs. The research showed that 73.1% of the interviewed enterprises "were not familiar with or blind to" the policies provided by the country, that 62.7% of them hope to get information service. Shanghai Municipal of China Zhi Gong Party also made similar research during which 82% of the SMEs thought that they were "not familiar with the government's preferential policy for them"<sup>[8]</sup>. Of course, one important cause of that is the lack of legal professionals.

SMEs can't expand operations through financing because they are not familiar with relevant laws and regulations. This fact also indicates that SMEs don't do well in protecting their own rights and interests by law. As many preferential policies on financing require MSEs to declare to relevant authorities, and comply with relevant procedures, MSEs may miss such opportunities if they are not familiar with them, thus missing good chances of financing and growing business. With faint legal awareness, MSEs always defend their own interests by "relationships methods", not by the law when their own economic interests are violated. These approaches always lead to unnecessary economic losses and bad results, thus weakening ability of MSEs to further develop.

### **Incomplete understanding of themselves**

A survey of SMEs owners conducted by Zhejiang federation of industry and commerce shows that more than 70% of the owners have high school or below degree. In addition, a survey of SMEs owners conducted by Chongqing federation of industry and commerce shows that 80% of SMEs manager have college or below degree, among which only 20% of them have college and above degree.

As quality of staffs in SMEs including the manager is relatively low, so SMEs don't know well in future development direction, financial management system, financing space and environment, management of financing and so on. As SMEs don't know well about themselves, they don't adopt scientific approach to development and philosophy, so on the one hand, the enterprise future profitability and scale expansion are limited and the endogenous financing ability is further restricted; On the other hand, the finance department staffs are not familiar with financing channels, and couldn't break the constraints of inertia to find new financing channels because of their limited culture level.

## **COUNTERMEASURES AND SUGGESTIONS ABOUT FINANCING PROBLEMS OF SMES**

### **Developing relationship lending**

Commercial Banks and other financial institutions will require companies to provide collateral or guarantor to avoid the incomplete information situation. However, SMEs often couldn't provide collateral of enough value or guarantor with limited business scale and poor system. The relationship lending could solve these problems well, because it pays more attention on manager's moral quality, present situation of the enterprise management, first repayment source of enterprise and expected cash return on investment project; it contains much "soft" information which is collected by loan officer during the long-term cooperation between enterprises and financial institutions.

To small and micro enterprises, another important measure of developing relationship lending is micro-credit technology, which develops from the long-term cooperation of small and micro enterprises and financial institutions. Financial institutions should delegate more power to loan officers and heads of branch banks. For they have more connections with enterprises and know the operation state and credit level most. Thus, they can reach the most accurate risk assessment.

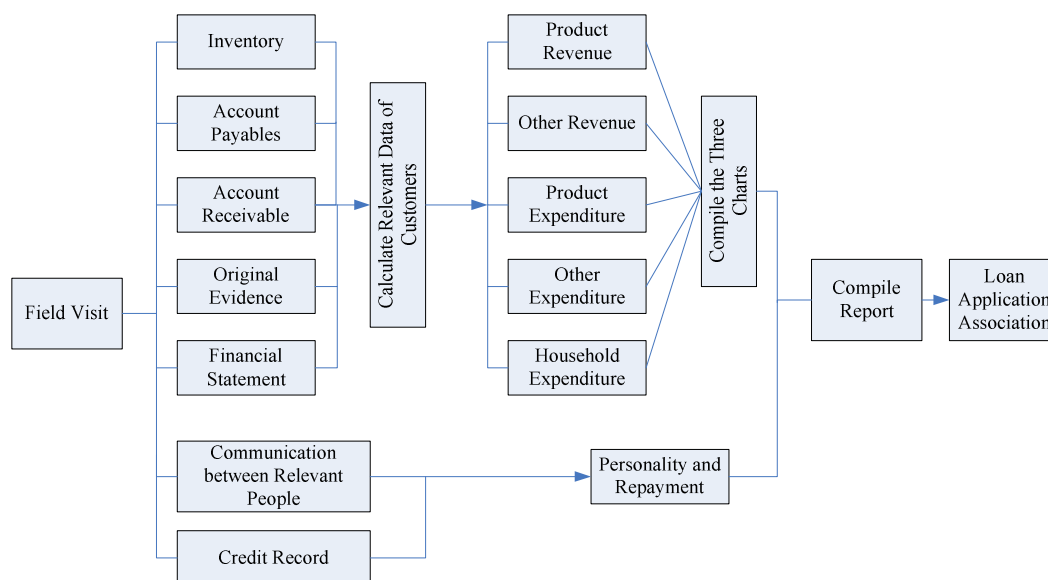
As a complete loan system, micro-credit technology is features with high institutionalization and process management. Professional officer are needed in the operation process, as is shown in Figure 2.



**Figure 2 : Operation process of micro-credit technology**

Marketing refers to the process that loan officer contact with local enterprises initiatively. Based on marketization, prices is decided upon the risk premium, financing cost and managing cost of each loan. The interest rate varied from the specific credit rating. Dunning is also an essential part in micro-credit. With comparatively low education, many managers would default or repudiate their debts. Therefore, the managers should correct their bad credit concept timely. As to the enterprises who default, correspondingly dunning policies should be made.

Investigation before loan, as an essential part in small-credit, should operate as follow in Figure 3. Three charts refer to balance sheet, cash flow statement and average monthly profit and loss account.



**Figure 3 : The procedures of Pre loan investigation**

### **Strengthening disclosure of small and micro enterprises**

Micro and small enterprises should disclose their financing condition initiatively and honestly. Excessive return can be get through hiding or even disclosing false information in short term. However, in the long term, this would influence their credibility of the loan, so as to make the enterprise miss the opportunities or even fail. On the contrary, an honest disclosure and investigation of financial institution can reverse the information asymmetry between enterprises and financial institutions. Hence, the financial institutions would be more willing to lend to the enterprises.

### **Strengthening managers' cognition to micro and small enterprises**

As to the incomplete information problem in micro and small enterprises, managers should strengthen their cognition to their enterprises. This calls for the constant improvement of their comprehensive quality and management. The managers should continuously learn economics and management, deepening their knowledge of future development, financial management, financing space and environment, and financial mode.

Besides, due to the incomplete information between micro and small enterprises and government, the manager or financing officers should raise their law-consciousness, strengthen their study on financing policies, local economy development plan and economy development budget. Through this, managers would discover their advantages in the development plan timely and stimulate the development of enterprises.

## **CONCLUSIONS**

This essay focuses on the financing problems of micro and small enterprises through incomplete information and put forward resolutions based on the present situation. Through research, the main barrier of financing is the enterprises' inadequate understanding of relevant laws and regulations and their own conditions, and financial institutions' inadequate understanding of enterprises. In accordance with these questions, this essay put forward such resolutions as micro-credit technology, strengthening disclosure of enterprises' financing information and deepening the managers' cognition to the enterprises.

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